HIPC DEBT RELIEF: WHICH WAY FORWARD?

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

APRIL 20, 2004

Printed for the use of the Committee on Financial Services

Serial No. 108–79

U.S. GOVERNMENT PRINTING OFFICE

94–515 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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HIPC DEBT RELIEF: WHICH WAY FORWARD?

Tuesday, April 20, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE, AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:30 p.m., in Room 2128, Rayburn House Office Building, Hon. Judy Biggert [Vice Chair of the subcommittee] Presiding.

Present: Representatives Biggert, Feeney, Oxley, Maloney, Frank, and Bell.

Mrs. BIGGERT. [presiding] The Subcommittee on Domestic and International Monetary Policy will come to order. It is my pleasure to have witnesses here today and to welcome all of you to today's hearing on HIPC, or highly indebted poor countries, debt relief. We are here today to hear testimony and encourage discussion of a report released last week by the General Accounting Office concerning the possible cost of the enhanced HIPC program. The Financial Services Committee under the leadership of Chairman Oxley and Ranking Member Frank requested this report so that the members of this committee could have a better sense of the possible costs of the enhanced HIPC initiative.

I might add that you might have noticed that I am not Chairman Peter King; I am the Vice Chair, Judy Biggert. Mr. King will have an opening statement for the record but he could not be here today.

[The prepared statement of Hon. Peter T. King can be found on page 39 in the appendix.]

The GAO report presents some very troubling estimates. It indicates that if HIPC countries are to benefit long term from their debt forgiveness, they are likely to need between now and the year 2020 significant continued assistance from the international lending community. In particular, the GAO estimates that an additional $153 billion will be needed in development assistance and another $215 billion will be needed to, and I quote, "fund export earnings shortfalls." This would all be in addition to an expected $8 billion in debt relief likely to be needed when countries reach their completion point and the topping-up portion of the HIPC debt relief program is triggered. The grand total is $375 billion through 2020.

The GAO also tells us that these are conservative estimates that could easily rise. Of course the estimate is a global number. If the past is any guide, the United States could be called upon to contribute a portion of the estimate, about 12 percent. This may be a

small portion, but it represents a large number, $52 billion over the next 18 years. If the GAO numbers are on the mark, this would probably work out to $2.8 billion per year to U.S. taxpayers. I probably am not the only Member of Congress that would question the wisdom of allocating that kind of funding for the next 18 years without further serious discussion and consideration.

This GAO report will generate serious discussion. There will be questions about its assumptions and methodology. People rightly will point out that there exists no formal commitment from the multilateral lending banks or donor countries to make up for export earnings shortfalls. People rightly will point out the difficulty of accurately estimating development assistance needed by the HIPC countries for the next 18 years, especially if one assumes business as usual with no change in lending practices.

Finally, people will question whether it is appropriate or correct to assume that export earnings and HIPC country exposure to export and commodity price volatility will remain more or less the same.

I come from Chicago where commodities markets for years have helped our farmers hedge exposure to the same kind of commodity price volatility that complicates development assistance. I understand that the World Bank is exploring how to make better use of the commodities derivatives markets to help poor countries reduce the exposure their economies and export sectors have to price volatility. I also understand the World Bank is looking at how in the future it might approach lending decisions differently in order to prevent a linear accrual of debt burdens.

And so I welcome this GAO report for the questions it raises. It gives Congress and other policymakers a sense of how expensive it could be if current lending and business practices in the development community do not change. It provides us with a concrete sense of the magnitude of the task at hand. It also provides a good basis for development experts to debate how further development assistance should be conducted in the future. And it raises additional questions that are not limited to the following: Does it make sense to continue lending to poor countries in all circumstances? What limits on lending should occur? What is the appropriate role of grants? Is it fair to refer to new grants as debt relief? How can developed donor countries facilitate policy changes and enhance access to modern financial hedging instruments that can help support countries' development choices? And finally, what can debt relief reasonably be expected to achieve and is it asking too much for debt relief to resolve broader development problems?

Debt relief under the HIPC program already has begun to improve lives in impoverished countries. I look forward to hearing from our witnesses about what specific progress has been made. I also look forward to a spirited discussion of how to facilitate progress within HIPC countries. We want to learn from the failures of development lending in the past and explore the availability of new approaches that can help countries develop more responsibly in the future. I personally am not convinced that providing billions of dollars to support export shortfalls is a good use of anyone's resources, especially when other alternatives might exist to help countries develop more efficiently functioning markets.

The GAO report makes clear that a failure to identify a delineation between debt relief, property reduction, and development assistance goals will be costly for U.S. taxpayers and people all over the world.

With that, I will recognize the Ranking Member, Mrs. Maloney from New York, for an opening statement.

[The prepared statement of Hon. Judy Biggert can be found on page 32 in the appendix.]

Mrs. MALONEY. I will defer to the ranking leader, Mr. Frank, if you would like to open and I will follow you.

Mr. FRANK. I thank my colleague. I appreciate the chairman of the full committee's accommodating us by having this hearing. We tend when we have hearings to focus on problems and criticisms in areas where we can do better, which is appropriate, but sometimes the underlying reality gets lost. The underlying reality has been that this has been quite successful.

I appreciate the fact that two witnesses from the NGO sector, who are both representative of organizations that did a great deal to get us here, recognize this. There are some real concrete improvements for some of the poorest people in the world that came out of the HIPC.

Secondly, I don't want the HIPC criticized for what it was not intended to do. Particularly the $375 billion figure is a figure well within reason but not to carry out—and the GAO didn't suggest that—the specific goals of the HIPC, of the highly indebted poor countries. The fact is, a very small amount is needed in relative terms for that. The 375 is a very worthy goal, but it is not the case that if we don't get $375 billion—and I think the world could afford it over that 30-year period—that somehow this would be a failure.

The next point I want to make is—and let's be very clear when we talk about debt relief—we are not talking in any realistic sense about letting people who incur debts in any morally relevant sense out from under. The debtors here are countries, and in almost every case the residents of the countries were the victims of those who incurred the debts. This is not a case of individuals going out and spending recklessly, and now saying I don't want to pay my debts. As a matter of fact, many of us in the West have more responsibility for these debts than the people who are now bearing their burden, because it was in many cases the governments in the West, seeking in some cases to pursue geostrategic goals, who helped these countries incur the debt. That ought to be very clear. This is not one of those cases where we are letting people off a hook that they got themselves onto.

We have some of the poorest people in the world who have been twice victimized by bad governance; one, by the abuses they suffered during the period of those governments being in power, and secondly by the long-lasting burden of the debts those governments incurred from which the people in the countries very often got no benefit.

We are in the process of trying to reduce that debt. That does not solve all the problems. I am concerned about what seems to be an instinct to be negative far beyond what is required. The Department of Treasury put out a report in October of 2003, comments on proposed modifications to the enhanced heavily indebted poor

countries. It responded in part to legislation that has been suggested by some of the organizations, the gentleman from New Jersey (Mr. Smith) and I and others worked on to try and talk about going further. I was particularly disturbed on page 8 to read the following quote from the Treasury's report: As highlighted in the World Bank's operations evaluation department's evaluation of the HIPC program, continued focus on HIPC and debt relief has been a distraction in terms of the greater emphasis needed on well-defined economic growth strategies in these countries. The OED report stressed that HIPC debt relief is not a panacea, and that given institutional capacity constraints in the HIPCs, debt relief is not an efficient way of achieving desired social sector outcomes.

Those comments are inaccurate, they are damaging, and I do not regard them as having been made in good faith.

It is true that the OED report stressed that debt relief is not a panacea. I am prepared to ascribe to the general statement that nothing is a panacea. I have never seen a panacea. Maybe they exist somewhere. The role of panaceas is to be a stick with which people can beat things that they are in favor of and can think of nothing substantively bad to say about them.

Of course it is not a panacea. No one ever said it was. It is helpful, as we will hear again from some of these witnesses.

While there are some points of improvement here, I very much regret the negative spirit in which Treasury writes these comments. When I saw that, I was troubled and went and got the World Bank's report. That simply does not accurately convey what the World Bank's report said, and I would hope that the Treasury would be willing to correct that.

Just a couple of last points. One debate where I do agree with Treasury and with this administration, we had a year ago—I hope it is over by now, I think the witnesses are on the right side—for some reason when the administration proposed that we substitute grants for loans to poor countries, some of my ideological allies, not used to ever agreeing with this administration, objected. I think the sides got switched there and people got—it is like those old comedy routines where people are saying yes, no, yes, no; and somebody says no and the other guy switches to yes.

Of course grants are better than loans. Improvident grants aren't good. Improvident loans aren't good. But everything else being equal, grants make more sense than loans when you are trying to keep people from getting into debt. I think we should be moving more in that direction, both with the multilateral institutions and bilateral institutions.

Finally, I agree, and Mr. Hart makes this point: We ought to be going beyond that with regard to debt relief, and in particular I believe we should be working with the multilateral institutions, particularly the World Bank and the IMF, to get them to give the same degree of debt relief that was given bilaterally. After all, the multilaterals are in fact the sum of the bilaterals. They are not independent entities that make their own money. They get money from elsewhere.

Particularly with regard to the IMF—and I want to pursue this, and I would ask people to join me—they did some monetization of their gold and were able to pay for some debt relief. They can go

further. I don't know if we can get 100 percent. It is harder with the World Bank than the IMF to come up with a funding source, but there is no reason why the IMF should not now be pressed to go back into this process of monetizing some of their gold which is undervalued and use some of those proceeds to give greater debt relief. That is one of the specifics that comes out of this for me.

Madam Chair, I thank you and I thank the Ranking Member of the subcommittee for her recognizing me.

Mrs. BIGGERT. I thank the gentleman.

The gentleman from Ohio, the Chairman of the Committee on Financial Services, is recognized for an opening statement.

Mr. OXLEY. Thank you, Madam Chairwoman. Thank you for chairing this hearing today on an important issue for the global community. Last year, Ranking Member Frank and I requested that the GAO analyze financing issues associated with the initiative led by President Bush, at the Group of Eight level, to enhance debt relief for the most indebted countries in the world. We also asked the GAO to identify options for providing additional relief to help countries achieve debt targets, debt sustainability and lower debt service burdens.

Providing humanitarian relief to the world's poorest nations is a duty of the United States and developed nations around the globe. The question is not whether to provide humanitarian aid but how to use the taxpayers' money most effectively in our quest to lift these nations from the depths of poverty.

I look forward to receiving the GAO's testimony this afternoon as well as the reaction to the report from two leading organizations, DATA and the Catholic Conference. The HIPC initiative has already had a positive impact on the lives of real people around the globe. Our witnesses will provide some details on how funds within HIPC countries have been reallocated away from debt service and towards funding education and inoculation programs. I also understand that the process within HIPC countries for identifying how these funds should be allocated is strengthening democracy and civil society participation in government decision-making.

While there is a long way to go in many of these countries towards full democracy, these are encouraging first steps. However, HIPC debt relief is a limited tool. It seeks merely to decrease debt service burdens for the poorest countries on the planet. It identifies as goals, but not commitments, broader ideals such as reducing poverty and increasing export earnings within these countries.

Today's GAO report is controversial because it attempts to estimate the costs that could be associated with achieving these broader goals. The estimates in this report are sobering. GAO estimates that the cost of achieving both debt relief and economic growth targets in HIPC countries could be at least $375 billion between now and 2020 in present value terms. Even if the U.S. portion of this amount is as small as 20 percent, this is still a serious amount of money that will cause policymakers to consider carefully and strategically development assistance strategies.

I welcome this report because it will require policymakers and development experts alike to devote renewed attention to distinguishing debt relief from development assistance. It also identifies the possible cost of continuing to do business as usual in the multi-

lateral development banks. By assuming that business practices in the banks do not change and by assuming that export growth in HIPC countries will not be materially enhanced in the future, the GAO report shines a spotlight on the need for donor countries, development banks, and HIPC countries to renew efforts to find new ways of delivering development assistance, so that in the future poor countries do not amass crushing debt burdens.

I am encouraged that the World Bank is already thinking in these terms. In a February 2004 report on debt sustainability in low-income countries, it explores the possibility of countries using market mechanisms such as derivatives markets to hedge their exposure to commodity market volatility. It is actively considering a new framework for lending to low-income countries that would limit the amount of debt a country could acquire. These are encouraging developments. As we discuss HIPC countries' need to expand and diversify their export sectors, I would also like to underscore the importance of reviving the Doha round of trade talks. Reduced trade barriers will provide all countries with opportunities for growth and development.

I look forward to today's testimony and continued efforts to enhance the effectiveness of international development assistance. I yield back the balance of my time.

Mrs. BIGGERT. The gentleman yields back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 34 in the appendix.]

The gentlewoman from New York (Mrs. Maloney) is recognized for 5 minutes for an opening statement.

Mrs. MALONEY. Thank you very much. In the interest of time, I will request unanimous consent to place my comments in the record and merely state that I am looking forward to the panelists' statements on the new GAO report of the HIPC program.

We do know that where debt relief has been accomplished, it has been very successful. I have a series of examples in my statement that show where it has truly helped return children to school and helped to vaccinate children in Tanzania, Uganda, Mozambique, and others where debt relief savings were used to really provide essential services and education and health care to some of the world's poorest people.

I support this program. I look forward to the testimony. I will place my 5-minute statement into the record. Thank you.

Mrs. BIGGERT. Without objection, all members' opening statements will be made a part of the record. Are there further statements?

Then we will proceed to the witnesses. Today we have Mr. Tom Melito, Acting Director, International Affairs and Trade, United States General Accounting Office. Welcome.

Mr. Thomas H. Hart, Director, Government Relations, DATA—Debt, AIDS and Trade for Africa. Thank you for coming.

And Mr. Gerald Flood, Counselor, Office of International Justice and Peace, United States Conference of Catholic Bishops.

I am sure that most of you probably know the drill. Without objection, your written statements will be made a part of the record and you will each be recognized for a 5-minute summary of your

testimony. Then we will ask questions with a 5-minute limit which we will try and stick to.

Mrs. BIGGERT. I will first recognize Mr. Melito for your testimony.

STATEMENT OF THOMAS MELITO, ACTING DIRECTOR, INTERNATIONAL AFFAIRS AND TRADE, UNITED STATES GENERAL ACCOUNTING OFFICE

Mr. MELITO. Madam Chairwoman and members of the subcommittee, thank you for the opportunity to be here today to discuss GAO's assessment of funding challenges related to heavily indebted poor countries, or the HIPC initiative. The HIPC initiative is a joint bilateral and multilateral effort to provide debt relief to poor countries to help them achieve long-term growth and debt sustainability.

Our recently released report has two main findings. First, the three key multilateral development banks we analyzed, the World Bank, African Development Bank, and Inter-American Development Bank, face a funding shortfall of $7.8 billion in present-value terms under the HIPC initiative. We estimate that the United States could be asked to contribute an additional $1.8 billion to close this financing shortfall.

Second, we estimate that the 27 countries that have qualified for debt relief may need more than $375 billion from donors to ultimately achieve their economic growth and debt relief targets by the year 2020. The United States may be asked to contribute about $52 billion of this assistance.

Let me briefly provide some background on the HIPC initiative and then describe in greater detail the results of our work. The World Bank and IMF have classified 42 countries as heavily indebted and poor. Three-quarters of these are in Africa. The current cost for this initiative is about $41 billion in present-value terms. This will be funded almost equally between bilateral and multilateral creditors. A major goal of the HIPC initiative is to provide recipient countries with a permanent exit from unsustainable debt burdens.

I will now turn to our main findings:

First, regarding the financing issues for the current initiative, the three banks we analyzed face a funding shortfall of $7.8 billion in present-value terms. The World Bank has the largest shortfall at $6 billion. Despite significant assistance from donor governments, the African Development Bank has a financing gap of about $1.2 billion. The World Bank and the AFDB have not determined how they will close their financing gaps. The Inter-American Development Bank is fully funding its HIPC obligation by reducing its future lending by $600 million beginning in the year 2009. We estimate that the United States could be asked to give an additional $1.8 billion to close the $7.8 billion shortfall.

However, the total estimated funding gap is understated, because the World Bank does not include costs for four countries for which data are considered unreliable. In addition, all three banks do not include estimates for topping up, the additional relief that may be provided due to factors such as a weakening in countries' economic

circumstances. The World Bank and IMF project that this additional relief could cost from $877 million to $2.3 billion.

Let me now turn to our second finding, addressing countries' long-term economic growth and debt sustainability. The 27 countries that have qualified for debt relief may need more than $375 billion in present-value terms to help them achieve their economic growth and debt relief targets by the year 2020. This amount consists of three components: first, $153 billion in expected development assistance; second, $215 billion to cover lower export earnings; and, third, at least $8 billion to reach debt targets.

The World Bank and IMF project that these countries will need $153 billion in development assistance after HIPC. However, this is an underestimate because it assumes that countries will achieve overly optimistic export growth rates. Under more realistic historical rates, we found that 23 of the 27 countries are likely to experience higher debt burdens and lower export earnings. This will lead to an estimated $215 billion shortfall over 18 years. These shortfalls are due to weather and natural disasters, lack of access to foreign markets, or declining commodity prices, all factors outside these countries' control. If countries are to achieve economic growth rates consistent with their development goals, donors would need to fund the $215 billion. Otherwise, countries would grow more slowly, undermining progress toward poverty reduction.

Finally, we estimate that countries will need at least nearly $8 billion to achieve their debt targets, both those under the existing initiative and those the committee asked us to examine. Based on its historical share of bilateral and multilateral assistance, the United States may be asked to contribute about $52 billion, or 14 percent of the $375 billion in additional assistance.

Madam Chairwoman, this concludes my prepared statement. I would be happy to answer any questions you or other members of the subcommittee may have. Thank you.

Mrs. BIGGERT. Thank you very much.

[The prepared statement of Thomas Melito can be found on page 79 in the appendix.]

Mrs. BIGGERT. Next, Mr. Hart, if you will proceed.

STATEMENT OF THOMAS H. HART, DIRECTOR, GOVERNMENT RELATIONS, DATA, (DEBT, AIDS AND TRADE FOR AFRICA)

Mr. HART. Thank you, Madam Chairwoman. Mrs. Maloney, Mr. Frank, and other members of the subcommittee, I would like to talk briefly about what has been achieved by the HIPC debt relief program, which has been significant; how it can be improved and how debt relief compares to other forms of assistance, which is a lot of ground to cover in a short amount of time, and I hopefully can react briefly to the GAO report at the end. I will be happy to answer any questions you might have as well.

First, let me say what a real pleasure it is to address this subcommittee on this critical issue. While DATA, which stands for Debt, AIDS, Trade, Africa, is a relatively new organization, many of the people who helped found DATA started their work during the Jubilee 2000 campaign. The best known of whom, of course, is Bono from U2, who is the co-founder of our organization. But also some of the most influential people in the debt campaign are actu-

ally members of the U.S. House Financial Services Committee. I would like to thank Mr. Leach, Mr. Bachus, Mr. Frank, Ms. Waters, as well as many others of this committee, who created the essential authorizing legislation as well as the political momentum to approve the HIPC initiative and get it funded here in the United States, which then had the impact of triggering the international agreement among the other donors.

Over the last 4 years, Congress has provided approximately $860 million to the enhanced HIPC initiative, canceling both U.S. bilateral debt and contributing to writing off multilateral debt. And I am delighted to report that the results of this program have been substantial. Twenty-seven of the poorest countries in the world have now qualified, almost all of which are in sub-Saharan Africa. These countries will see their debt reduced by two-thirds, cutting $52 billion in debt stock.

Other donors, in addition to the United States, have provided $30 billion to finance this initiative. A new process has emerged in which poor country governments must engage with their civil societies to determine poverty reduction priorities for their country and have increased ownership and transparency within their governments. For development advocates like DATA, very importantly, more than $1 billion annually in debt service is now staying in these 27 countries to fight poverty.

And just a couple of brief examples: Uganda has used savings from debt relief to more than double school enrollment to 94 percent, which has contributed to that country's remarkable decline in HIV/AIDS rates. Mozambique has vaccinated children against tetanus, whooping cough, and diphtheria as well as built and electrified schools. And Cameroon has used debt savings to launch a national HIV/AIDS plan for prevention, education, testing and mother-to-child transmission.

So, being the Financial Services Committee, what kind of return on this investment have you got? For an investment of less than $1 billion over the course of several years, the U.S. has leveraged $30 billion of donations from other donors and canceled $50 billion of debt stock, a significant clearing of the books of decades-old debt. It also has freed up $1 billion a year in debt service which is now building schools, clean water wells, and AIDS prevention programs.

That said, of course, the program could be improved. The debt service relief has been rather uneven among the 27 countries, some receiving 5 percent debt service to revenue, others up to 34 percent. We are hoping that we can even out some of the benefits in the program.

Secondly, 27 countries is wonderful, but not enough. There are many countries who could benefit from debt relief. As we have seen recently in Iraq, any reconstruction and development package should include debt relief as a way of easing financial pressure on a burdened country.

And thirdly, even though these countries have saved $1 billion annually in debt service, they are still paying $2.5 billion annually, mostly to the World Bank and IMF. These are critically needed resources for putting girls in school and fighting AIDS.

So it is with some of these improvements in mind that Mr. Frank, along with his colleague Mr. Smith from New Jersey here

in the House, and in the Senate, Senator Santorum and Senator Biden, drafted legislation to try to address some of these concerns. Very quickly, it proposed a simple change to the HIPC program. Instead of using 150 percent debt stock to export, which is the measure the current HIPC initiative uses to measure debt, it proposes to change so that no country spends more annually in debt service than 10 percent of its general revenues, or, in the case of a country with a high AIDS burden, 5 percent. That would more closely link debt relief to a country's ability to pay and limit some of the volatility that changing exports have had on debt sustainability. It would increase the amount of money these countries have for poverty reduction by over $430 million, a 50 percent increase in the benefit to these poor countries for only a minimal cost.

This proposal was actually passed into law last year with the Global AIDS Act, but the Administration has not yet implemented its provisions. I hope one of the outcomes of this hearing will be to encourage the Administration to do so.

In my last minute of time, I want to relate how debt relief works as part of a development package. Of course debt relief, as Mr. Frank noted, is not a panacea. It never was designed to be. Poor countries need additional aid and much better trade terms with rich countries, something that speaks to the GAO's very large gap in export financing that they have in their report. But debt relief under HIPC does have several features that make it an effective form of assistance.

(1)It coordinates donors. Like any bankruptcy, all the donors have to move together and that eases the burden of paperwork, financing, and accountability that poor countries have to deal with.

(2)It promotes country ownership. The HIPC initiative, as I mentioned earlier, asks members of civil society to design a poverty reduction plan, creating better consultation by the countries themselves as well as highlighting country priorities rather than donor priorities.

(3)Debt relief gives untied aid, meaning the countries make their spending decisions themselves.

(4)And, as noted, debt relief leverages far greater sums because it coordinates the donors together. As noted, every U.S. taxpayer dollar is leveraged 30 times by other donors.

Very, very briefly on GAO, Tom is an old friend so he will know the spirit in which I say this, but this was GAO's shock-and-awe strategy. Even though this was a report intended to address some of the challenges of debt relief, he ends up bringing in export financing and development assistance as a way of achieving certain growth goals. While DATA firmly supports a robust and comprehensive development financing package for the poorest countries, to somehow imply that the debt relief programs shoulder that burden is simply not going to happen.

One of the factors that I have pointed out, the largest gap in financing here that the GAO points out is in export financing. I know this will be a controversial suggestion to Congress, particularly during an election year, but instead of actually costing the U.S. taxpayer money, we could in some respects solve this problem by saving taxpayer money. U.S. farm subsidies contribute dramatically to Africa and other poor countries' inability to export their

goods to the Western world. We spend billions of dollars subsidizing our farm products, which make them very, very cheap and make it very difficult for poor countries to compete globally. In many instances also those products are actually dumped on markets in poor countries. Therefore, that export gap could be closed by other means other than U.S. taxpayer dollars.

The shortfall in debt relief that is mentioned, the $8 billion, could largely be addressed. It is partially being addressed currently—there is a $650 million shortfall, of which the United States has agreed to provide $150 million, half of which has already been appropriated by Congress. The other half has been requested for 2005. It is a very small amount. The second part of that shortfall is largely to the World Bank. This is because to date, the World Bank has taken its substantial annual profits and transferred some of those profits to the HIPC initiative. It has done that to date and is now proposing to stop doing that. That is the reason why the shortfall exists.

I hope some of these issues can be considered as the committee moves forward. Thank you very much.

Mrs. BIGGERT. Thank you very much.

[The prepared statement of Thomas H. Hart can be found on page 54 in the appendix.]

Mrs. BIGGERT. Mr. Flood, you are next.

STATEMENT OF GERALD FLOOD, COUNSELOR, OFFICE OF INTERNATIONAL JUSTICE AND PEACE, UNITED STATES CONFERENCE OF CATHOLIC BISHOPS

Mr. FLOOD. Thank you, Madam Chairman. Madam Chairman, members of the subcommittee, on behalf of the United States Conference of Catholic Bishops, I would like to thank the members for the opportunity to testify here today. Debt relief for poor countries has been a high priority for the Bishops Conference and of the relief and development agency, Catholic Relief Services, for many years. In my testimony, I will be focusing on a number of issues at a level of technical detail which the Bishops would not normally address and on which they therefore would not have a position, as I think you can understand. Thus I am offering my testimony primarily as a former development agency official who has worked on debt and related issues with both the World Bank and the Bishops Conference for many years.

First I would like to reiterate what Tom Hart said and just to acknowledge my great appreciation and gratitude for the leadership and the long and faithful support provided by many members of this committee in favor of debt relief for heavily indebted poor countries, particularly Mr. Leach, Mr. Bachus, Ms. Waters and Mr. Frank.

In my written testimony, I discuss six areas where the HIPC program and related activities seem to be producing good results for the beneficiaries, including, among others, substantial increases in expenditures for poverty reduction, prudence in new borrowing and improved processes for tracking poverty reduction expenditures. Time won't permit me to go into each one of these, but what I would like to do is just highlight one of them and then as is our

wont, as suggested by Mr. Frank, to go into some of the deficiencies for the program as I see them, but briefly.

The first point I want to make on the positive side is that the poverty reduction strategy process, or the PRSP which was introduced as an integral part of the HIPC debt reduction program, has facilitated an active, unprecedented role for civil society groups in monitoring of expenditures for poverty reduction. Catholic Relief Services reports impressive examples of civil society participation in a number of countries including Bolivia, Uganda, Malawi and Zambia. They have formed active and effective debt monitoring organizations which actually examine and track how debt relief expenditures are being spent in their countries. This shows that in many countries the procedures instituted under the HIPC program are helping to strengthen democratic processes in places where historically weak governance has often led to serious neglect of the needs of the large majority of the very poor and vulnerable citizens.

On the other side of the ledger, although the program is in its fifth year of completion, only 11—and I understand yesterday that number is up to 12—of the 27 beneficiary countries have reached their completion point. This is the point at which they become irrevocably entitled to full debt relief. Zambia is a case in point. My understanding is that the completion point is being held up because pressures to increase salaries led to an overshooting of the wage bill target agreed with the IMF. This is a very complex issue. A recent World Bank report analyzed the wage bill problem. It says that low remuneration in the public sector is a major factor contributing to problems of poor productivity, motivation, recruitment and retention. At the same time, the wage bill in Zambia has remained large relative to overall government expenditures, thereby crowding out operational expenditures.

The World Bank report outlines a broad strategy for addressing the issue. But the challenge is an enormous one: how to make wages sufficiently remunerative to attract and retain qualified staff while at the same time minimizing the cost. In the meantime, Zambia continues to be plagued by a heavy burden of past debt. In fact, the fiscal bind which Zambia finds itself in can be attributed in large measure to its heavy debt service obligations. According to the latest projections, Zambia's debt service will be an extremely high 31 percent of government revenues in 2004. The delay in granting full debt relief is restricting the ability of HIPC countries to create the kind of fiscal space so important for moving ahead to address in a more effective way the human needs of their people.

The IMF and World Bank should reexamine the conditions for reaching the completion point, particularly those that are unrelated to assuring that the debt relief savings will reach the poor.

Tom Hart has already covered the next several points and I don't want to waste the committee's time by repeating things which I am in full agreement with. I just want to thank very much Representatives Chris Smith and Barney Frank, and Senators Santorum and Biden for their leadership in introducing the bill which is now the new legislation which Tom Hart discussed.

So let me talk briefly about the GAO report. This report makes a very important point, which is that even if the HIPC program is fully financed, substantial additional external assistance will be re-

quired to enable HIPC countries to achieve growth and poverty reduction targets. Debt relief is not—a well used word—panacea. Even if the existing debt of HIPC countries is reduced to zero tomorrow, it will not end poverty. The problem is too complex and deep seated for that. It must be addressed first and foremost by the countries themselves, with their governments and people working together on a variety of fronts for the common good. But they are too poor to do it alone. They need additional aid and support from the wealthier countries.

There are questions of course that arise with respect to the numbers that are used in GAO's report, but let me make one additional point and that is that the GAO scenario assumes that the export shortfall they project will be made up entirely by aid. This overlooks an important element of the development agenda—external trade, as Tom Hart indicated. Developing countries can achieve important benefits by more open trade provided that it is also fair trade. The World Bank estimates that trade barriers in Europe, the United States, and Japan cost poor nations more than $100 billion a year.

One final point. The GAO estimates that almost all the 27 HIPC countries could achieve debt sustainability if multilateral creditors converted an average of one-third of their new loans to grants. In fact, in a statement by President Bush in 2001, he said that IDA should convert about half of its loans into grants. The Bishops Conference supported the expansion of IDA's grant authority in IDA 13. But they also emphasized the importance of donors beginning to make contributions very soon to offset the loss of reflows of loan payments to IDA which constitute close to 40 percent of their resources for new lending. Otherwise, the necessary contributions would mount quickly to unfeasible levels and cause IDA to sharply cut back its assistance to the world's poorest countries. This will be an important issue in the negotiations of IDA 14 which have just begun. Thank you.

Mrs. BIGGERT. Thank you very much.

[The prepared statement of Gerald Flood can be found on page 45 in the appendix.]

Mrs. BIGGERT. We will now proceed with the questions. I will recognize myself for 5 minutes.

Mr. Melito, your report identifies a range of development and export support lending that will be needed between now and 2020 for HIPC countries to meet the targets identified in their PRSP. Do your estimates take into account the impact that programs such as the Millennium Challenge Account, the Global Fund for HIV/AIDS, TB and Malaria, the USAID, and UNCTAD will have in helping to meet some of the development needs you identify in your report?

Mr. MELITO. In our report, we are using World Bank and IMF's 20-year projections which make the assumption, which we follow, that these countries are on a reform program that is supported by the donors, which would include bilaterals such as the United States as well as multilaterals. We hold that assumption constant. So U.N. reforms, World Bank reforms, U.S. reforms, would all be assumed to be followed. This would then result in high GDP growth rates, which we hold constant. So yes.

Mrs. BIGGERT. So yes?

Mr. MELITO. We are assuming those sources of financing are there and the reforms that those particular programs are looking for are being followed.

Mrs. BIGGERT. Have you actually taken into account the monetary amount, or is that just that these reforms will raise the quality of the health, for example, of the people of those countries?

Mr. MELITO. Once again we have used the World Bank and IMF's breakdown of development assistance, which doesn't go into great detail. It has information on different multilaterals, how much the World Bank will provide, how much the other MDBs will provide. It also has very general numbers on the bilaterals. It doesn't break it down to how much is actually the U.S. share, and certainly not within the U.S. Share how much would come from MCA versus regular development assistance. We abstract from that. We are just taking the total numbers they provide us.

Mrs. BIGGERT. For example, with the Millennium Challenge Account, what would you say about that?

Mr. MELITO. That would be one of many possible sources of financing which could be used to help the HIPC countries as well as other HIPC countries as we move forward. But it is not, in the case of financing HIPCs, different from any of the other sources. It is one of many possible options.

Mrs. BIGGERT. How about, then, the Global Fund for AIDS? We put so much money into this program. I am trying to just figure out if you would say, well, so much money is going to go to this?

Mr. MELITO. It is a very difficult thing to project out 20 years. We tried to put a lot of caveats in the report. We are actually, for the most part, piggybacking on the World Bank and IMF's projections, just changing some key assumptions and seeing what the impact of those assumptions are. They are the ones who estimated how much development assistance would come to the countries. We don't actually change that number. We leave that number as it is. So when we say that $153 billion is expected in development assistance, that is the World Bank and IMF's number. That is not our number. That number is about equally distributed between multilateral assistance of about $75 billion and about $78 billion for bilateral assistance. But they don't actually break it down and say how much is coming from the global fund, how much is coming from MCA or anything else. And that is certainly not within the scope of what we did. So we left that as is.

Mrs. BIGGERT. How do you determine the rate of growth each year, how much of this is going to factor in for the years to reach 2010?

Mr. MELITO. The DSA has a number of optimistic growth rates. We made a choice to keep the optimistic GDP growth rates constant, because those are the rates which are geared towards poverty reduction, with the notion that these countries will be expected to strictly follow the reform programs which will contribute to their ability to grow, and in exchange for following reform programs, donors would provide them assistance.

We also, though, looked at the fundamental—we considered—weakness in one of their growth rates which is on the export side. We think it is important to highlight that. While we find that there is a $215 billion export shortfall, we still calculate that these coun-

tries are going to raise quite a bit of revenue from exports. It is not that we are wiping out their export revenues. It is just that we bring a more realistic historical perspective and our estimate is about 40 percent of what the World Bank and IMF estimate. But we have reasons to suspect the export levels. We are being hopeful on the GDP side for the value estimated.

Mrs. BIGGERT. There has been recent research that has begun to quantify how improvements in public health can drive economic growth. With some of the written testimony and testimony today on how inoculation and other health initiatives have been supported by the HIPC initiative and these other administration priorities, how can one assume that export growth in the future will be consistent with the historical experience?

Mr. MELITO. The reason we are concerned about the export growth rates is that a lot of the vulnerabilities come from factors outside these countries' control. As we mentioned in our statement, they rely heavily on a few primary commodities, agriculture products like coffee or cocoa, minerals like copper. Over the last 20 years, the prices of these items have actually gone down over that time in real terms. They have wide fluctuations which also hurt these countries. These countries also have large weather extremes, other natural disasters. So on the export side, they really have very little that they can sell, and what they are selling has been going down in price. For them to have good outcomes in exports, they need to diversify their exports and probably moving into manufacturing, which would be an important development goal, but it takes a long time for them to reach that point.

Mrs. BIGGERT. Thank you. I recognize the gentlewoman from New York.

Mrs. MALONEY. I would yield to the Ranking Member of the full committee.

Mr. FRANK. I thank the gentlewoman.

Mr. Melito, one thing that I think may have caused some confusion, when you talked about the $375 billion, which of course $8 billion of that is for the HIPC—we ought to be clear—the HIPC. To carry out what we started a few years ago cost $8 billion. So the overwhelming majority of that is to get to very, very good outcomes. We might say that $368 billion is the price of a panacea which we claimed we were doing there. But even there I think it may mislead some people unless we are very explicit about something.

As I understand what you are saying, that is not $375 billion more than is currently planned. That includes $153 billion that is assumed foreign aid going forward. So even at that, it is a $215 billion increment, currently planned amount, over this period, is that correct?

Mr. MELITO. That is so. We are explicit about that in the report.

Mr. FRANK. I understand that. I don't mean to impugn your pride of authorship. But some people might wait for the movie and not read every word in the report, so I wanted to get that out. So we are talking not about $375 billion additional but $215 billion additional to reach the point where they are all in very good shape. I would love to get there, but I don't want to scare people.

The only other thing I would ask about were exports. You are right, exports are uneven but not with regard to agricultural commodities but with regard to, you mentioned copper and other things. We are currently in a situation where with sanctions of the Chinese vacuum cleaner, some of those things are going up. Do you assume that is going to end soon? In fact, while export prices for raw materials might have been going down a while ago, currently my reading is that a lot of them are going up because China is putting such upward pressure on them. Do you have any response on that?

Mr. MELITO. Even over the last 20 years, there have been periods of growth, but the overall trend has been downward. Certainly some of the commodities may be turning around.

Mr. FRANK. If the Chinese continue this?

Mr. MELITO. Overall demand worldwide may be going up but they are still vulnerable.

Mr. FRANK. I agree. In fact, that also leads me to the last point I want to make on this. That is, I have been struck, as we have debated free trade over the years, that some of us who have been concerned about the impact that unrestricted trade without any labor or environmental rights would have on particularly some of the industrial workers who have been accused of being protectionists. In fact, as I think this report makes clear, the greatest negative impact any public policy in America has on our ability to help poor people is America's agriculture policy. It is restrictive, it is subsidized, and I find it odd that people who are strong proponents of our agricultural policy, which I generally vote against, which costs tens of billions of dollars and is quite restrictive, are somehow allowed to call themselves free traders.

I gather with regard to export growth that significantly increasing the amount of agricultural product we allow to come into the United States would be very helpful. Is that correct?

Mr. MELITO. It is generally outside the scope of this report, but we do highlight that the ability to sell their products will obviously decrease this shortfall.

Mr. FRANK. Would you say that agricultural products are a large part of what these particular countries would be able to sell?

Mr. MELITO. Their primary commodities are generally agricultural or metals.

Mr. FRANK. Thank you. I think that is kind of an illogical point here. The most protectionist, the aspect of American economic policy that falls hardest on these countries is our restriction on agriculture.

I guess finally I would say this. You don't seem to be too optimistic about the impact of various free trade agreements that the United States might be signing with these countries. Have you taken that into account? Suppose the President and Mr. Zoellick's trade agenda were put through. Would that increase your optimism about their exports?

Mr. MELITO. Certainly to the extent that markets would open, that would increase their ability to achieve high growth.

Mr. FRANK. But there is nothing in there. You wouldn't bet on it?

Let me ask Mr. Flood with whom I generally agree, this one point—and I did want to note that I think some of our liberal friends were just wrong in their resistance to going to more grants, although it does mean that you have to take advantage of the reflows. But one point that was raised by Treasury and some others, and I know I supported this amendment with Mr. Smith but we did, I think, give Treasury an alternative. We said either do this or come up with an alternative. I share your disappointment that Treasury basically just blew us off and sent back a report which I think unfairly denigrates the HIPC and mischaracterizes what the World Bank said. But there is the moral hazard thing. There is the perverse incentive thing. How do we respond to that? I must say I am impressed with that. Namely, that if you tell people that we will make sure that their debt isn't more than a certain percentage of their revenue, to some extent that gives them an incentive to kind of push up their debt and reduce their revenue. Are there ways that we can achieve the goal of reducing the burden of debt and avoid those negative incentives, Mr. Flood?

Mr. FLOOD. I have never really understood that point too well, because we have a situation where a country is paying, let's say, 30 percent of its revenue currently in debt service. Under the legislative proposal that was passed, the country would then go to a situation where it is paying perhaps 5 percent of its revenues in debt service. Therefore, it is in effect in a position where it makes more sense to go out and raise revenues because fewer of its revenues are going to have to be used up in providing funds for debt service.

Mr. FRANK. What about if they are closer to the margins where an increase might have a negative impact?

Mr. FLOOD. I think that the other thing is that this is a retrospective program. It is not a prospective program. What we are talking about is getting rid of old debt.

Mr. FRANK. I know that it has been suggested that one of the things you do is to have these be only as applied to the past but that future either debt or revenue would somehow be excluded from the calculation, Mr. Hart?

I am sorry. Go ahead, Mr. Flood.

Mr. FLOOD. I was going to say that I think in going forward, I don't think that the countries can expect to have repeats of HIPC every few years, which it seems to me would create quite a moral hazard, that they wouldn't in effect be responsible for the debt service of future lending because somebody's going to always come around and forgive it. But if you went to a grant system, which I think is really a very good alternative, it will avoid that problem.

Mr. FRANK. Mr. Hart?

Mr. HART. I was going to respond to the first part of your question, which is that Treasury has argued that somehow when you have a debt service-to-revenue formula you are somehow depressing—that you are creating an incentive not to collect revenues. And it was in response to that that you and your colleagues who passed the legislation gave Treasury the flexibility to design another mechanism which achieved similar results, including tying it to GDP, which has been an example that Nancy Birdsall from the Center For Global Development has recommended. That option is there for Treasury to pursue.

Mr. FRANK. Let me say to Treasury that I would renew our request that they give us more on this than they have. I think there is a great deal of interest.

Just a last point on this, if I could, Madam Chair, and I thank you for the indulgence. Unfortunately reflective of—I don't know—a lot of things, we are more sparsely attended today than if we were talking about richer people.

Mr. FRANK. I can see how we can get the IMF to finance greater debt relief. I think we need to do some more work on how we get the World Bank to do that, because it seems we ought to be going forward on that.

There was one suggestion that they raise the interest rate on sort of middle-income countries. I do not think that works. I do not think you want to make Mexico pay for Uganda. That is not a good idea.

But any off-the-top-of-your-head suggestions about what we can do with the World Bank? And that would be my last question.

Mr. HART. Just briefly, ask the World Bank to do what it has been doing for the last 5 years. As part of the enhanced HIPC framework, the World Bank agreed to take net profits it earns from interest on income—between $1.5 billion and $2 billion a year, in net profits. They then transfer that to their pension plan and to other accounts. One of those accounts that they transfer profits to is the HIPC trust fund.

They have been giving between $200 million and $300 million a year as their part of contributing to writing off this HIPC debt. They have agreed to do that until 2005.

Between 2006 and 2020, they have not agreed to do so, thus creating that massive shortfall in funding that GAO referred to.

Mr. FRANK. So they just agree to continue this forward if they could do that, and it would not cause shortfalls in the other accounts?

Mr. HART. It would at least substantially reduce that shortfall.

Mr. FRANK. Mr. Flood?

Mr. FLOOD. No, I just wanted to say that even when they are contributing $240 million to the HIPC trust fund out of their revenues, they are still able to increase their general reserves by $2.4 billion. I mean they have a lot of leeway in there.

Even with the continuation of the current level of contributions to the HIPC, there will be still a gap, and I think that really the $240 which they are currently doing has to be considered the minimum as to what they can contribute going forward.

Mr. FRANK. So that would not get us to further debt? That is just to finish up on HIPC?

Mr. FLOOD. That is right.

Mr. FRANK. We have to work on that.

Mrs. BIGGERT. Thank you.

It appears that the gentleman from Massachusetts would be in favor of another hearing at some point.

Mr. FRANK. Yes, I would be.

Mrs. BIGGERT. To include Treasury and perhaps the World Bank.

Mr. FRANK. Yes, although, we did not ask Treasury. I do not mean to be critical of Treasury, because they have been cooperative. We had not asked them to come here.

But yes, I think because the World Bank will not testify, but they could sit and listen, and maybe they are already doing that.

Yes, I thank the vice chair. If we could get Treasury to come back, or to come—it is not their fault today, we did not ask them—but if they were to come and address this, that would be helpful. And maybe the American ED, the American executive director of the Bank, could accompany Treasury.

Mrs. BIGGERT. The gentleman from Florida is recognized for 5 minutes.

Mr. FEENEY. Thank you very much, Madam Chairman.

I happen to be a new Member of Congress and, of course, a new Member of the Committee. And this is my first experience with HIPC, so I hope you will give me the grade 1 through 5 and not the advanced level.

I want to ask first, Mr. Melito from the GAO, with respect to your study, you named the donor nations that are eligible for HIPC. You also I think we probably admit, as some of the folks on the other side tried to point out earlier, that there are huge variables when you start estimating the burdens that these countries are going to have, all sorts of things, not just gross domestic product increases but the value of specific resources, whether it be oil or gold or commodities or products, all sorts of political decisions that are made, not just by that Nation, but by the world community. I think we very much understand that.

One of the things I would be interested in knowing is, historically, how some of these poor debtor nations got into the condition they are in the first place. One of the things that I would be specifically interested in, since it is something we have an impact on, is what their history has been over the last 3, 4, 5 decades in terms of receiving foreign aid. What have we done with our foreign aid dollars to actually help these folks acquire the types of governments and policies that will lead them to economic prosperity?

I note that one of the key goals of HIPC is not just to relieve debt. I mean, that is the symptom that we are attacking, but it is to eliminate or reduce poverty and promote economic growth. And I guess sort of the tongue-in-cheek proposal from somebody who has been very disappointed in a 50-year history of financial aid from America and other nations and how little it has actually impacted the quality of life of people there, I guess sort of the tongue-in-cheek proposal is, have we thought about translating the Wealth of Nations by Adam Smith into all of the different languages available and providing it to the finance ministers and advisers and economic professors in each of these countries?

Because my view of this is pretty simple. Our policies are not designed to promote not just free trade but low taxation, low regulation, the rule of law, property rights, both for real and intellectual, that no amount of aid is going to be enough to keep these countries out of deep trouble. So if I could—and I will end early, Mr. Melito, because then I would like to have the other panelists if I could, who are advocates for aid—I would sort of like you to address your response to my monologue here, to how we know when we are succeeding.

We really are trying to remodel what I have described as a massive failure of foreign aid from America for the last 4 or 5 decades.

By the way, the only exception is maybe some short- or even long-term intelligence or military with strategic advantages. If we are going to buy or bribe countries to be our friends for a while, that would be a different discussion.

But to the extent our goal is economic growth and reduction of poverty, I have been totally disappointed in the results that foreign countries have gotten from our aid and that our taxpayers have gotten as well.

Some of the things, Mr. Hart, that you point out that are huge successes—and I do not mean to diminish the importance of any of these—but I would like you to tie the ultimate goals of HIPC programs, eliminating and reducing poverty and promoting economic growth. You have twice as many people in schools in Uganda. Are they teaching the right things to twice as many students? You are measuring inputs there, and I am more concerned if we are measuring outputs.

I think that, finally, and then I will end, if you can tell me how you are measuring—and by the way, you talked about disease control and AIDS. Africa is three-quarters of the nations involved here. Famines come and go in Africa in a tragic way, not every decade, but every year. Even when the famine is eliminated, poverty is not, and economic prosperity never, ever results on the African continent. And that is a sad fact of life.

Finally, Mr. Flood, you have suggested that Malawai and Zambia are examples of where HIPC may be making a difference, but this is more of a suggestion on your part. Do you have any empirical evidence that you can give us to that effect?

So with that, thank you very much.

Mr. MELITO. I will just briefly talk a little bit about history and let my colleagues deal with the effectiveness.

The causes for these countries getting these debt problems is actually an ongoing issue of overly optimistic export growth rates. Back in the 1970s, these countries received a lot of commercial debt or debt from governments, including the United States, at commercial rates, on the notion that they would be growing rapidly. Well, they did not, and in the 1980s, they ended up having very high levels of debt which they could not pay.

That debt got slowly converted over time from bilateral to multilateral debt, as they went to the concessional windows. But this problem has been existing for a couple of decades, and failure to reach high export growth rates would be one of the main causes of this debt, going back since the 1970s.

Mr. HART. Thank you, Congressman.

There is a lot of, many parts to your question, and I am not sure I will do justice to all of them. Let my try.

First of all, I do not think it would be correct to say that the last 40 years of development aid have been a categorical failure. Life expectancy rates in the developing world from World War II to the 1990s was actually increasing, which is a real output, to use your word, of direct assistance. Then HIV/AIDS began to take its toll, particularly in Africa, and we have seen life expectancy decline.

That is not to say that I disagree with everything you are saying. I do actually agree. I think we could do a lot better with our development assistance. I think, actually beginning with debt relief 5

years ago, began a trend toward several things that have improved U.S. assistance and indeed the global fight against poverty. One is that donors are acting better in concert with one another. That does, in fact, have a real impact on these countries.

I think also the ability of countries to leverage money from one another increases the impact of assistance.

I think in no small measure the success, political success, of debt relief and the results that we have begun to see, at least the input that we have begun to see in these countries with debt relief, have helped lay the groundwork for the substantial increase in assistance for HIV/AIDS. Beginning with Mr. Helms in the Senate who was a long-time critic of U.S. aid, his support for debt relief and then HIV/AIDS helped begin to turn the corner.

And I think that also has led to the Millennium Challenge Account, which, in my view, is an historic rethinking of the way we do development assistance—focusing large amounts of resources on well-governed countries, countries fighting corruption and promoting democracy. And we are firm supporters of that program and look forward greatly to the Administration implementing this program with haste, because we do think that we will begin to really see the results that we are all hoping for, as well as revealing the credibility of aid with the American public and with policymakers.

Mr. FLOOD. In terms of aid effectiveness, I think that, for one thing, we do not often really appreciate some of the smaller improvements that are actually happening on the ground at the micro level that do not get built up and put into the global statistics. Because I remember when I was working for the World Bank in Nigeria, I visited a rural community. What was going on there is amazing, even though it will never appear in any statistics anywhere, in terms of what was happening with a group of maybe 500 people, something like that.

They had, through technical assistance, introduced new varieties of cassava, a basic commodity for them, and they had doubled the output of the cassava in a few years time. They had new water supply systems, and these were, of course, wells, simple, just wells in the middle of a town. Before, the mothers would have to travel for miles to get water out of a river which was usually polluted. And now, they did not have to travel so far. They could spend their time on more productive ventures, and the water that they had was pure. It did not cause them to get sick all the time.

These sorts of things do not always show up in the statistics. They take a long time to filter up and to spread, and maybe impact on, the global economy of that particular country.

Malawai and Zambia—I have not been there, so I cannot give you a very precise answer. But what I can tell you is that one of the problems with aid deliveries in the past has been the question of ownership. Too often the countries did not really feel that they owned the activities that were being financed by the external donors because too much of the time they were the donors' preferences and priorities and not the local people's preferences.

I think an important thing about the Malawai and Zambia experience is that civil society is having a major role which they did not so much have in the past. They are really influencing the shape of

the programs, and more than that, they are able to monitor what happens.

Now, even in the HIPC program, it is too early to have any solid measures of outputs. You are really stuck, for the time being anyway, mostly with input measures, but the input measures are good. I mean, the fact that so many more school children are attending primary school in Uganda, I think that is a major accomplishment. All the donors that I am aware of, they have programs for teacher training, for improving the curriculum.

In Nigeria, we financed 1 million textbooks, which were geared to the local environment, for example, to primary school children. So the input side, I think, is important, and I am confident that we are going to see some good output measures, output coming out of all of this.

Now, again, I think the development agencies also are improving their techniques for measuring outputs, and I think that is a positive sign.

Mrs. BIGGERT. The gentlewoman from New York, Mrs. Maloney, is recognized for 5 minutes.

Mrs. MALONEY. I have a question for Tom Hart on the ability to pay.

Last year, in the Global Aids Act of 2003, the United States committed to seek deeper multilateral debt relief. The current enhanced Heavily Indebted Poor Countries Initiative sets 150 percent debt-to-export ratio as the index of debt sustainability.

Secondly, the Administration has yet to implement the 10 percent of fiscal revenue measure of ability to pay. So Mr. Hart, and GAO, Mr. Flood, if you would like to comment, can you elaborate on these two measures of ability to pay and, more broadly, in your opinion, has the Administration, the Government, complied with the mandate in the Global Aids Act to seek deeper debt relief?

Mr. Hart?

Mr. HART. Thank you. I can answer the last question fairly quickly, which is, not yet. And again, this hearing, I hope, will spur the Administration to consider the recommendation the Congress gave them in the AIDS law, building upon the enhanced HIPC framework, in beginning to seek deeper relief for these qualified countries.

The primary motivation of this legislation is to change, as you said, from 150 debt stock-to-export ratio, which is really in the weeds, and I apologize. Very quickly, the reason for that is, I mean, it is an arbitrary level. All of these numbers are fairly arbitrary. But one assumes that you would need exports, hard currency, in order to pay off international debt. So the notion was, great, we need to earn money from exports and that will be somehow related to our ability to write off international debts.

The problem with that measure, of course, is not only is it too high, but exports, as GAO has mentioned, are incredibly susceptible to shocks and commodity prices change. Uganda, which was our star performer under the enhanced HIPC framework, for a time actually became unsustainable under their debt portfolio because coffee prices went through the cellar. So no matter how well you are doing, your debt sustainability is overly affected by this.

So the notion in the legislation was to more directly apply debt relief or to relate debt relief to a country's ability to pay. These countries were spending 25, 30, 40 percent of their government budgets on interest on their debts. We were saying, no, that is a silly investment of this poor country's money. They should be spending it on putting their girls in school and digging clean water wells. So that is what this legislation tries to do.

As I mentioned earlier to Mr. Frank's point, the legislation actually does give the Treasury the flexibility to design another similar type mechanism if that one is flawed in some way.

Mr. MELITO. I would just like to add that, how to measure the sustainability has been a challenge since the initiative was created. There are weaknesses in every measure they have suggested, but the World Bank and IMF are actually looking at trying to address all of these concerns. Whether or not something will emerge remains to be seen, but they do recognize that there is no perfect measure.

Mr. FLOOD. I was just only going to add the fact that there is a real concern about the countries particularly that are suffering from HIV/AIDS. They really need to maximize the amount of their domestic resources they can use to fight that terrible scourge. That is part of the motivation behind the new legislation.

Mrs. MALONEY. I would like to ask a question about Iraqi debt, and even though they are not a HIPC country, there is a lot of effort and focus on Iraq. And I really applaud the Administration's efforts in Iraq for debt relief.

But I am concerned that by gaining only partial debt relief, and I have legislation in with Congressman Leach that would really erase all of these debts, with IMF and the World Bank taking the leadership role in that by reducing and erasing their debt first. But I am concerned that by gaining only partial debt relief, the value of outstanding debt may actually increase as the chance that countries might be paid for some of their debt increases. And I am concerned because I do not believe the Iraqi people should be saddled with Saddam's debts, particularly when they were odious debts spent for arms and palaces.

And certainly, I do not think that the American people should be sending aid for reconstruction to Iraq that may end up paying for debts that were incurred by the former regime.

Can you, Mr. Hart, address whether you believe the value of Iraqi debt outstanding may increase as partial debt relief is accomplished? And again, GAO, Mr. Flood, if you would like to comment?

Mr. HART. Well, let me handicap myself by saying I am not intimately familiar with the Iraqi debt case. But of course, you are describing a scenario which seems plausible, which is that as the Iraqi debt is lowered—and this is true for HIPC countries as well—what remains becomes more payable. Therefore, the discount value of that debt shrinks. You are more likely to have to end up paying off the face value than you were before.

Now, I do think the Iraqi debt case presents an interesting example, of course, and lessons to be learned as we look at other debt relief for other countries, which is that, indeed, when Saddam took on all of these debts and now he is gone from power, the country is left burdened with the debt. And that is, in fact, the case with

many of these African countries, many of these HIPCs. Dictators long ago have been replaced in some cases, and in many cases, surprisingly, by multi-party democracies, but being sovereign nations, they absorb the history left behind by corrupt dictators.

One of the notions of Jubilee 2000 and this enhanced HIPC initiative was the idea of providing a clean slate, giving them a fresh start, indeed for some of the very reasons that you cited.

Mrs. MALONEY. Just very briefly, I would like to ask GAO, why in the world did you intertwine the two issues? The HIPC program is directly focused on poverty alleviation. Helping countries to get a level of sustained economic growth is a larger, far more complex question. Why did you combine the two when that really is not what the HIPC program is, and the amount, as Mr. Frank mentioned, is astronomically larger when you put the two together? So I am just curious about your thinking on that.

Mr. MELITO. Sure. If you agree with the assumption that the export growth rates are overly optimistic—and most people do, and even the World Bank itself is agreeing that their growth rates are too optimistic—you then have to come up with an alternative set of rates. And we chose to use historical, and maybe something a little higher would be what someone else would use. But if you use lower rates, you suddenly find very large gaps emerge in the amount of resources these countries have available. Some of it is exports; some of it is debt.

If we were myopic about the issue and just reported how much their debt component was, we would be missing most of the story. And we were concerned about how to present the story, and I think we were very careful in how we wrote the report in making those different components clearly distinct of each other.

But if we just reported the $8 billion without reporting the export shortfall, I think we would be susceptible in a legitimate sense of missing the whole story or missing a big part of the story, so we had to report them both.

Mrs. MALONEY. Thank you very much.

I ask unanimous consent to place in the record the opening statement of Barbara Lee.

[The following information can be found on page 41 in the appendix.]

Mrs. BIGGERT. Without objection, so ordered.

Now, the gentleman from Texas, Mr. Bell.

Mr. BELL. Thank you, Madam Chair.

I would like to thank the panel for your testimony here today. I just have a couple of questions. First, for Mr. Melito, and it is really a follow-up to something you were discussing with Congressman Frank regarding the situation involving China. You pointed out that all of these projections are somewhat difficult. But looking at China and realizing that its bubble could burst at some point and its demand for developing world exports could be greatly diminished, is there any way for you to tell us here today how that might impact some of the projections in your report?

Mr. MELITO. I want to be quite clear that we actually do not look at that level of detail, although those are one of a number of factors which create the vulnerability which these countries face in export growth. There are many reasons, including potentially a particular

market that was open to them now closing. China right now has been increasing its demand for certain commodities, and we do not know if that will sustain overtime.

Mr. BELL. So it would be fair to say, any situation like that would impact and could impact your numbers?

Mr. MELITO. When we used 20 years of historical rates, we wanted to basically cover good years and bad years. If you look at the history of these countries, there are a number of years for many of these countries, 3, 4 years in a row where they had very rapid growth. If you just cut off the story there, you might say the problem is solved. But often those periods of rapid growth are followed by periods of large declines that persisted.

There are always circumstances. You point to a market that opened up to them or something, but then something else changed. We considered 20 years forward, which is what we did, and the most representative is to go 20 years back.

Mr. BELL. I see.

Mr. Hart, in your report that you gave us, you point out, on page 7, after talking about the debt legislation, despite debt legislation being law for nearly a year, the Administration does not pursue negotiations with international partners to implement its provisions. I am sure you find that a little bit alarming, and probably, the best folks to address this question to would be representatives of the Administration, but we do not have that opportunity today.

So I am just curious if you have been able to receive any information on that particular topic as to why the Administration has not pursued any negotiations.

Mr. HART. There are reasons, and yes, we have spoken with them about this. And their reasons are varied, including a general sense, that at the boards of the Bank and the Fund, there is not support for going further. Actually, DATA is an organization that works not only here in the United States but in London and other capitals around the world. And the sense to improve the HIPC initiative actually is fairly strong, from our perspective.

Fundamental to their critique is, as I mentioned earlier, a feeling that tying debt relief to revenues is a disincentive to collect taxes. If you have smaller revenues, then you owe less debt.

Our response to that has been, as Mr. Flood indicated, there is actually no evidence to suggest that that is what has happened, that that sort of reverse incentive would take place. But in response, the legislation described actually does try to address that and say, come up with another measure that would avoid that disincentive to collect revenues.

Third, and I think most importantly, and it is cited both in Treasury's report and in GAO's testimony, is the funding gap of the current initiative. They are hesitant to try to increase the relief of the current initiative until it has been fully paid for. And that is an understandable position. However, I believe the way that both GAO and the Administration have presented the shortfall case overstates the problem, and I do not mean that lightly. I mean that the Administration, with the donor community has already taken strides to meet that gap and, as I testified earlier, the World Bank, if the World Bank will continue to do what it has already been doing, that gap will be substantially reduced.

I think, as a final point, I would just like to advocate for the legislation. It was quite expensive to get rid of a lot of the debt stock that was not being serviced. We got rid of this huge amount of debt stock at a cost $30 billion, to which the United States contributed $1 billion.

And we have just begun to get at some of the debt that was being serviced, thus relieving resources on the ground for building schools and wells. Every dollar that we put in from now on, because these countries are actually paying this debt back, actually generates benefits on the ground. So the return for the countries now is amplified if we take it an incremental step further.

Mr. BELL. I just have one last question, and I will begin with Mr. Flood. And I guess this is really one of the major questions that needs to be resolved and is somewhat of a follow-up to what Mr. Feeney was saying.

I certainly understand the need for this debt relief and am fully supportive of it. But I think we all fear becoming a precedent or an example and that countries will look on future borrowing as somewhat artificial borrowing, that at some point, there will be enough political pressure brought to bear in the United States and across the globe to forget the debt, and it just becomes a recurring situation.

I am just curious what recommendations you all have to keep that from happening and keep that from becoming the situation.

Mr. FLOOD. Well, there are many, many aspects to that. I think one is that the countries have to continue to try to address better their development problems. I think that we see evidence through this HIPC program of some advances in that direction. I mean the basic challenge is for the countries themselves to strengthen their economies in a way in which they can develop their creditworthiness to continue to be able to borrow.

On the moral hazard issue, I think that there are several ways to address that, but I think that the best one for these very, very poor countries is to consider a larger percentage of grant financing. I think they are going to have to have that. It would be nice if we could say, it should all be grants, but I do not think the donors are that generous, that the entire amount that they need would be able to be provided through the grant process.

One thing that is encouraging, again in the HIPC program, is that the expected levels of post-HIPC borrowing by these countries has been quite modest. I mean, any kind of reckless borrowing has not occurred since the HIPC program. As a matter of fact, the Bank did the funding projections as to what they anticipate a prudent level of borrowing for these countries would be, and the numbers show that they are borrowing actually less than that right now.

So there is more prudence. I think there ought to be a larger percentage of grant financing in what they receive. The poorest countries are going to, obviously, need more, relatively speaking, than the more—well, they are not wealthy, that is not the right word—but higher-income poor countries, if we can call it that, would require.

Mr. HART. Just briefly, to amplify that I completely agree. It is not DATA's nor would I assume the Catholic Bishop's intention to

be here again in Jubilee 2050, to keep coming back because we have gotten ourselves into this problem again.

I have to say that the Administration ought to be applauded for their initiative in trying to convert some of these loans to grants. It makes absolute sense, and we have supported it. And it is trying, in fact, to address that prospective problem, trying to avoid getting back into it.

What we have not sufficiently dealt with are the problems of the past. We are still cleaning up some of that mess and have some work to do. They are complementary ideas meant to keep the poorest countries from being burdened by an unsustainable debt level.

Mr. MELITO. As we discuss in our report, the mix of the optimum level of grants for each country results in basically the loans they do take being ones that they should be able to repay. So it does provide an open and honest bookkeeping process, so they get grants in those areas where they cannot pay and loans for the resources they can repay.

Mr. BELL. Mr. Hart, I think it is completely fair to say that it is not Mr. Flood's intent to be here in 2050 discussing this same subject.

Mr. FLOOD. Oh, but I beg to differ.

Mrs. BIGGERT. Thank you very much.

We will have another round, I guess.

Let me ask again, Mr. Melito, recent World Bank research suggests that debt thresholds are dynamic, and specifically, they indicate that countries that advance and improve their policies and institutions will be able to sustain higher levels of debt.

Do you agree with this analysis? And is this concept included in the report's projections, or do the GAO projections assume that all countries' official sector debt is equal?

Mr. MELITO. The report uses the agreed-upon measure for HIPC, which is the 150 percent debt-to-export ratio, which my colleagues discussed previously.

But as I mentioned earlier, there are other possible measures, and the World Bank and IMF are exploring those measures, but they are not policy yet. If they actually ever change the initiative, we would probably in future work integrate that, but it is not the policy yet.

Mrs. BIGGERT. Okay. Then the World Bank this year published research providing a substantially different assessment of projected debt-to-export ratios through 2023. I am sorry we do not all have a graph that shows the difference between the historical and the baseline that they use, and it really does show what Mr. Flood was just talking about, where it goes down while the historic goes way up by 2023.

So that methodology that they show rejects the reliance on historical data alone being appropriate to project the future debt service burdens. Are you aware of this methodology?

Mr. MELITO. Sure. They have, in recent years, the last couple of years especially, been doing sensitivity analyses where they have been trying to look at alternative rates lower than optimistic levels, and I am familiar with that. We could debate, and it is reasonable to debate what would be a reasonable proxy for the future.

We have done our own analysis on the previous 10 years. Well, if you use the previous 10 years, the average would be 4.5 percent compared to 3.5 percent for 20 years, still substantially below what they project. They project over 7.5 percent, about 7.7 percent.

If you use the most recent 10 years, you would reduce the burden to around $150 billion instead of $215 billion, and that would be a nice, substantial change.

But the point is, their reliance on overly optimistic data creates the impression there is no problem. They provide debt relief at the completion point. They then show us these 20-year projections, and countries look like they have no problems moving forward.

Well, we think it would be much more realistic if they actually used lower growth rates and showed that HIPC, while it is very important and it has done a lot of good work, it is probably not going to provide a permanent exit from debt problems.

Mrs. BIGGERT. Well, would you say that methodology might provide the Treasury with more flexibility?

Mr. MELITO. This should be something that the Treasury and the donors debate. I mean, it seems arcane on the surface what growth rates should be used, but there are policy implications. And it would probably be useful if the boards of the Fund and the Bank actually put this on their agenda to decide for future projections for HIPC countries. We should adopt some standard or maybe report two or three, a low estimate and a medium estimate and a high estimate. But their official projections only use what I consider a very high estimate.

Mrs. BIGGERT. If I might, I would submit the question for the record and perhaps you could give the GAO views on the merits of using the historical projections to assess HIPC needs relative to the World Bank methodology.

[The following information can be found on page 98 in the appendix.]

Mr. MELITO. Sure.

Mrs. BIGGERT. Then my next question is that I understand that the World Bank is exploring innovative use of financial instruments and other methods for helping HIPC countries hedge their exposure to the commodity price risk and thus stabilize their export sector.

What are your views on using the hedging instruments to decrease exposure to commodity price volatility?

Mr. MELITO. That is not something that we looked at, and I really would like to look very closely at it before I could comment on that.

It does seem like it would be difficult limiting it to poor countries because you would normally want to involve the private sector, and I do not know exactly how they would involve the private sector in these transactions. But if they have a paper about this, we could review it and potentially make comments.

Mrs. BIGGERT. And assuming that these instruments could be used for hedging, I would suppose then that estimates in the GAO report would need to be adjusted?

Mr. MELITO. Well, again, the paper would be theoretical. I would like to see their plan and then ascertain whether it is feasible to implement such a plan.

Mrs. BIGGERT. Okay. Thank you. I see everybody has left me.

Would you like to comment on that Mr. Hart or Mr. Flood?

Mr. HART. I do not think I have a specific reaction to your questions. They are largely theoretical and ones that I do not have a good answer to.

But I would like to just comment briefly again on GAO's report. Actually, I have very little argument with the assumptions that they have made about growth rates. The World Bank and IMF, as stated earlier, agree that those are optimistic.

I guess what I would challenge is the way that it is presented to the Committee, as though $375 billion is needed to make debt relief successful. That is not the question; that is neither the purpose of the HIPC debt initiative, nor do I think that necessarily helps the Congress or this Committee grapple with the issues of HIPC that are before it.

It also, I would just reiterate, counts money we are already spending. It also is an 18-year figure and global figure, not just the U.S. share.

In my written testimony, I went through the calculation—and I believe you said in your opening statement—that could roughly translate into $2.8 billion for the United States.

Well, if you look at the global AIDS initiative, the Millennium Challenge Account, existing bilateral development and multilateral development assistance that we give, as well as export financing to poor countries, we give a lot more than $2.8 billion already. So what this analysis does not, nor could it, provide is an assessment of what actions Congress might take and really the state of health of the HIPC initiative moving forward.

Mrs. BIGGERT. Thank you. That really goes back to my first question, which was, were these other factors really accounted for in this report? And the answer I guess was, yes, and yet I cannot figure out how that figures in, looking at that number.

Mr. HART. Well, I do not want to answer on behalf of GAO, but my understanding of their analysis is they took the World Bank estimate that the global community would provide. Fair enough. That seems logical. It does not assess what the United States actually has given or plans to give in development assistance moving forward.

Mrs. BIGGERT. All right. Thank you.

Mr. Flood, do you have any comments?

Mr. FLOOD. No. It is just that I think as I recall—and this may have changed, I have not been in the Bank for quite a few years—but what they used to do is to estimate a reasonable growth rate for these countries. In some respects it would have a certain optimism in it so that one could know that we were talking about countries that were on an upward path, moving towards a higher level of development. And then they would determine what are the financial implications of that in order to achieve that particular growth rate. And then they would fill the amount in, and that is where you get your numbers.

It comes out of starting with a growth rate which you think is realistic based on various parameters, and then you fill in the financing plan that is required to get there.

I am not at all an expert in this area, but I would say that I am pleased to see that the World Bank, in response to this GAO report, admits that their export projections have been too optimistic in the past. I think that is an important point, that they recognize that fact.

I think that perhaps just extrapolating from the past is too pessimistic. I remain more optimistic that the countries will be able to move forward to a situation where, through export diversification and other measures, plus some support from the outside on trade measures, that they will be able to reduce their export volatility more than is implied by just the historical rate of growth of exports.

Mrs. BIGGERT. Okay. In the past then, the Department of Treasury underscored the importance of distinguishing between debt relief, which would be defined as to include only decreased debt service burdens and broader development goals. Would such a distinction imply that the majority of the estimated costs presented in the GAO report would not be appropriate when considering debt relief?

Mr. FLOOD. Well, I think that what I got out of it all is that one has to say that debt relief is only one part of the total picture, and it is important, but far from sufficient.

You have to look at a lot of other types of assistance, changes in policies as a whole, a large number of different issues which must be taken into account in order to project out what the total package is that is required. But clearly, there are different types of instruments, different items on the agenda which have different financial implications that go well beyond what you can ever expect from a debt relief program.

Mrs. BIGGERT. Thank you.

Well, seeing that no other questions or questioners—I will note that some Members may have additional questions for this panel which they may wish to submit in writing.

Without objection, the hearing will remain open for 30 days for Members to submit written questions to these witnesses and place their responses in the record.

Mrs. BIGGERT. I thank you all for being here, your time and your expertise and being part of this panel.

With that, this hearing is adjourned.

[Whereupon, at 4:10 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 20, 2004

Opening Statement
Congresswoman Judy Biggert
Committee on Financial Services
Domestic International Monetary Policy Subcommittee
"HIPC Debt Relief: Which Way Forward?
April 20, 2004

Good afternoon. It is my pleasure to welcome you to today's hearing on HIPC or Highly Indebted Poor Country Debt Relief. We are here today to hear testimony and encourage discussion of a report released last week by the General Accounting Office concerning the possible cost of the enhanced HIPC program. The Financial Services Committee, under the leadership of Chairman Oxley and Ranking Member Frank, requested this report so that the Members of this Committee could have a better sense of the possible costs of the enhanced HIPC initiative.

The GAO report presents some very troubling estimates. It indicates that if HIPC countries are to benefit long-term from their debt forgiveness, they are likely to need, between now and the year 2020, significant continued assistance from the international lending community. In particular, the GAO estimates that an additional $153 billion will be needed in development assistance and another $215 billion will be needed to (and I quote) "fund export earnings shortfalls"). This would all be in addition to an expected $8 billion in debt relief likely to be needed when countries reach their completion point and the "topping up" portion of the HIPC debt relief program is triggered. The grand total is $375 billion through 2020. The GAO also tells us that these are *conservative* estimates that could easily rise.

Of course, the estimate is a global number. If the past is any guide, the United States could be called upon to contribute a portion of the estimate – about 12%. This may be a small portion, but it represents a large number -- $52 billion -- over the next 18 years. If the GAO numbers are on the mark, this would work out to $2.8 billion per year to U.S. taxpayers. I probably am not the only Member of Congress that would question the wisdom of allocating that kind of funding for the next 18 years without further, serious discussion and consideration.

This GAO report will generate serious discussion. There will be questions about its assumptions and methodology. People rightly will point out that there exists no formal commitment from the multilateral lending banks or donor countries to make up for export earnings shortfalls. People rightly will point out the difficulty of accurately estimating development assistance needed by the HIPC countries for the next 18 years, especially if one assumes "business as usual" with no change in lending practices. Finally, people will question whether it is appropriate or correct to assume that export earnings and HIPC country exposure to export and commodity price volatility will remain more or less the same.

I come from Chicago, where commodities markets for years have helped our farmers hedge exposure to the same kind of commodity price volatility that complicates development assistance. I understand that the World Bank is exploring how to make better use of the commodities derivatives markets to help poor countries reduce the exposure their economies and export sectors have to price volatility. I also understand the World Bank is looking at how

in the future it might approach lending decisions differently in order to prevent a linear accrual of debt burdens.

And so I welcome this GAO report for the questions it raises. It gives Congress and other policy makers a sense of how expensive it could be if current lending and business practices in the development community do not change. It provides us with a concrete sense of the magnitude of the task at hand. It also provides a good basis for development experts to debate how development assistance should be conducted in the future. And it raises additional questions that are not limited to the following:

- Does it make sense to continue lending to poor countries in all circumstances?
- What limits on lending should occur?
- What is the appropriate role of grants?
- Is it fair to refer to new grants as "debt relief"?
- How can developed donor countries facilitate policy changes and enhance access to modern financial hedging instruments that can help support countries' development choices?
- Finally, what can debt relief reasonably be expected to achieve, and is it asking too much for debt relief to resolve broader development problems?

Debt relief under the HIPC program already has begun to improve lives in impoverished countries, and I look forward to hearing from our witnesses about what specific progress has been made. I also look forward to a spirited discussion of how to facilitate progress within HIPC countries. We want to learn from the failures of development lending in the past, and explore the availability of new approaches that can help countries develop more responsibly in the future. I personally am not convinced that providing billions of dollars to support "export shortfalls" is a good use of anyone's resources, especially when other alternatives might exist to help countries develop more efficiently functioning markets.

The GAO report makes clear that a failure to identify a delineation between debt relief, poverty reduction, and development assistance goals will be costly for U.S. taxpayers and people all over the world.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

"HIPC Debt Relief: Which Way Forward?
April 20, 2004

Good morning. I would like to thank the Gentlewoman from Illinois for chairing this hearing on an issue of importance to the global community.

Last year, Ranking Member Frank and I requested that the General Accounting Office (GAO) analyze financing issues associated with the initiative led by President Bush at the Group of Eight level to enhance debt relief for the most indebted countries in the world. We also asked the GAO to identify options for providing additional relief to help countries achieve debt targets, debt sustainability, and lower debt service burdens. Providing humanitarian relief to the world's poorest nations is a duty of the United States and developed nations around the globe. The question is not whether to provide humanitarian aid, but how to use the taxpayers' money most effectively in our quest to lift these nations from the depths of poverty.

I look forward to receiving GAO's testimony this afternoon as well as the reaction to the report from two leading organizations: DATA and the Catholic Conference.

The HIPC initiative has already had a positive impact on the lives of real people around the world. Our witnesses will provide some details on how funds within HIPC countries have been reallocated away from debt service and towards funding education and inoculation programs. I also understand that the process within HIPC countries for identifying how these funds should be allocated is strengthening democracy and civil society participation in government decision-making. While there is a long way to go in many of these countries towards full democracy, these are encouraging first steps.

However, HIPC debt relief is a limited tool. It seeks merely to decrease debt service burdens for the poorest countries on the planet. It identifies as goals, but not commitments, broader ideals such as reducing poverty and increasing export earnings within these countries. Today's GAO report is controversial because it attempts to estimate the costs that could be associated with achieving these broader goals.

The estimates in this report are sobering. GAO estimates that the cost of achieving both debt relief and economic growth targets in HIPC countries could be at least $375 billion between now and 2020 in present value terms. Even if the U.S. portion of this amount is as small as 20 percent, this is still a serious amount of money that will cause policymakers to consider carefully and strategically development assistance strategies.

I welcome this report because it will require policymakers and development experts alike to devote renewed attention to distinguishing debt relief from development assistance. It also identifies the possible cost of continuing to do business as usual in the multilateral development banks. By assuming that business practices in the banks do not change and by assuming that export growth in HIPC countries will not be materially enhanced in the future, the GAO report shines a spotlight on the need for donor countries, development banks, and HIPC countries to renew efforts to find new ways of delivering development assistance so that in the future poor countries do not amass crushing debt burdens.

I am encouraged that the World Bank is already thinking in these terms. In a February 2004 report on "Debt Sustainability in Low-Income Countries" it explores the possibility of countries using market mechanisms such as derivatives markets to hedge their exposure to commodity market volatility. It is actively considering a new framework for lending to low-income countries that would limit the amount of debt a country could acquire. These are encouraging developments.

As we discuss HIPC countries' need to expand and diversify their export sectors, I would also like to underscore the importance of reviving the Doha round of trade talks. Reduced trade barriers will provide all countries with opportunities for growth and development.

I look forward to today's testimony and continued efforts to enhance the effectiveness of international development assistance.

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OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS
"HIGHLY INDEBTED POOR COUNTRY (HIPC) DEBT RELIEF: THE WAY FORWARD?"
APRIL 20, 2004

Thank you, Chairwoman Biggert for convening this very important hearing on debt relief. The Chair herself should be commended for her work on this issue. I also want to thank Chairman Oxley for making debt relief a priority for this Committee. I have been a strong advocate for providing debt relief to countries that cannot provide the most basic of services to their citizens because of crushing debt service burdens for a number of years. Back in 1999, when I first proposed debt relief legislation, the topic was unfamiliar to most on Capitol Hill. Accordingly, I am pleased that debt relief is today a high priority for the Financial Services Committee.

Today's hearing will focus on the Highly Indebted Poor Country Initiative (the HIPC Initiative) – a multilateral effort designed to provide debt relief to the world's poorest nations. So what are we really talking about today? We are talking about raising the standard of living in the most impoverished countries, those in most need, the most vulnerable, and the most helpless. Without debt relief these nations and their citizens are overwhelmed by debt far exceeding their ability to repay, admittedly, amounts which the prosperous nations of the world might consider small. These nations do not have the ability to both repay the debt and offer basic social and economic support to their own people.

The HIPC program has been somewhat successful in several nations. For example, Uganda has used debt relief savings to increase social expenditures substantially, particularly toward the goal of universal primary education. In just a few

years, primary school enrollment in Uganda increased from 56 to 96 percent. Mozambique has increased health spending by $13.9 million, and has begun a tetanus, whooping cough, and diphtheria vaccination program for nearly half a million children. Without the HIPC program, these reforms would likely be impossible, given the mounting debt-servicing requirements on those nations.

Unfortunately, a large amount of debt is still owed by many of the HIPC countries, and as a result some countries are receiving significantly less benefit under the program than initially envisioned or desired. For many participating HIPC governments, total debt service payments still absorb a large proportion of their government budgets. In many cases, HIPC nations find that they cannot address major crises facing their nations (fighting poverty, preventing HIV/AIDS, rebuilding infrastructure, etc.) because debt service payments crowd out almost every other priority. Hopefully, today's hearing will move us a step forward in ensuring that sufficient relief is provided to HIPC countries to achieve the poverty reduction and debt sustainability levels contemplated in the original program.

Let me close by saying what I said during the 105th Congress when the Banking Committee first considered debt relief at a hearing on June 15, 1999: debt relief is not an end in itself; it is a means to an end. It is not a total solution to poverty, to hunger, to disease; but it is the first step. It is a necessary step. It is where the journey should begin to free these countries of the burden of debt, the chains of poverty, the shackles of despair, to enable them to minister to the economic and social needs of their people, of their children. It is the first step in raising the standard of living of those living in these impoverished nations, those in most need, those most vulnerable, the most helpless.

Here is the choice. We can continue to require the debt to be paid, and as long as we require the debt to be paid, children will not be fed. Require the debt to be paid and children will not be clothed. Continue to require the debt to be paid, and children will not go to school.

It is our decision. Let us make the decision. Let us not withhold from these poor children clothes on their backs, food in their stomachs, the right to attend school. The decision is ours.

I yield back the balance of my time.

Remarks Prepared for Delivery by
Chairman Peter T. King
Subcommittee on Domestic and International Monetary Policy

Hearing on *"Highly Indebted Poor Country (HIPC) Debt Relief: The Way Forward?"*

April 20, 2004

Today's Subcommittee hearing focuses on several issues important to countries seeking debt relief assistance for poverty reduction, education and sustained economic growth. I would like to commend the General Accounting Office (GAO) for their hard work in preparing a timely and detailed report which draws some interesting conclusions pertaining to the HIPC initiative. I would also like to thank our panel of witnesses for taking time out of their busy schedules to testify before us today.

The HIPC program, created in 1996, was an important step in providing debt relief to the world's poorest and seriously debt-strapped nations. At the 1999 Group of Seven (G-7) Summit, an enhanced HIPC initiative was agreed upon to provide quicker and more significant debt relief to qualifying countries. Currently, 42 countries are eligible for HIPC debt relief; three-quarters of these countries are in Africa. The United States has not wavered on its commitment to help these indebted countries. In fact, the U.S. pledged to provide a total of $750 million to the HIPC Trust Fund, of which it has already contributed $600 million. In July 2002, at the G-8 Summit, the U.S. pledged an addition $150 million to fulfill its commitment. $75 million was appropriated this year with another $75 million requested in the Bush Administration budget for FY2005. This debt relief has helped countries like Tanzania increase their school enrollment to 3.1 million, and Cameroon is funding a national HIV/AIDS initiative. Without the HIPC program, it is doubtful these reforms could be achieved because of the crippling debt burden which confronted these countries.

Although we have witnessed some success stories with the HIPC program, the GAO study concludes future success will come at an even greater cost to contributing countries and multilateral development banks. Which leads us to today's hearing – where do we go from here?

I hope for a spirited discussion on the conclusions reached by GAO, especially the projected $375 billion needed to achieve economic growth and debt relief targets for 27 countries. As stated in the report, this figure is partially based upon unattainable export projections. However, I am interested in determining if this figure is solely reflective of debt relief, or does the GAO include poverty reduction and economic sustainability into their projection. In other words, should the definition of debt relief include strategies to help a country maintain a sustainable level of debt relief and expand its export capacity, or should we simply focus on 100 percent debt elimination?

Lastly, I am interested in your opinions on the debt-to-export calculation used to assess the level of HIPC debt relief. As you know, this debt ratio has been an important topic of discussion since President Bush signed into law legislation that calls for the inclusion of HIV/AIDS rates when calculating HIPC relief for countries. Of particular interest is the shift from the current debt-to-export ratio to a debt-to-revenue calculation when providing debt relief.

Although some disagreement may present itself regarding these issues, the United States will continue to live up to its obligations and help these indebted nations escape from the depths of poverty.

Again, thank you for time and I look forward to your testimony.

Congresswoman Barbara Lee
Statement & Questions for DIMP Hearing on HIPC
April 20, 2004

Statement for the Record

Let me first thank Chairman King and Ranking Member Maloney for holding this hearing today. And I also want to express my gratitude to Mr. Frank, the Ranking Member of the Full Committee for his persistent efforts to see that this hearing was finally placed on the committee calendar.

I would also like to make special mention of my colleague on the committee, Maxine Waters, for her strong leadership on the issue of debt cancellation and reduction.

I appreciate the opportunity to examine the Highly Indebted Poor Countries (HIPC) initiative in more detail, and I welcome the comments of the General Accounting Office, as well as those of DATA and the US Conference of Catholic Bishops.

I want to speak briefly about the intersection between debt relief, poverty, and the HIV/AIDS pandemic in the context of Africa.

Today Africa as a whole owes a little over $300 billion worth of debt to the international community.

Because of this, the average African country today spends three times more of its scarce resources on repaying debt than it does on providing basic services.

That means less money is available to address poverty, education, infrastructure development, chronic malnutrition and famine, and in this day and age, the urgent public health crisis posed by HIV/AIDS.

In last year's Global AIDS bill, we tried to expand the HIPC program to emphasize debt relief for countries heavily affected by HIV/AIDS, but to this day, the administration continues to drag its feet on implementing even this conservative measure of debt relief for the African people.

If we are serious about stopping AIDS in Africa, we must address poverty, famine and development in a real way.

But how can we even begin to make a dent with the measly $2 billion in foreign aid we provide Africa, when African nations transfer over $15 billion dollars in debt repayments out of the continent each year?

Indeed, while HIPC represents an attempt to go beyond our traditional conception of development assistance, we cannot stop there. We must expand the scope of our debt relief initiatives and support the concept of debt conversion, so that countries may funnel their debt repayments into the development of their own infrastructure.

Ultimately the issue of debt, particularly odious debt, will only be resolved once we agree to cancel all of it. That is why I am a strong supporter and an original co-sponsor of my colleague Maxine Waters' bill, the Debt Cancellation for the New Millennium Act.

Question #1 (For Treasury Department)

While I am glad that we are holding this hearing today, I'm disappointed that we do not have a representative from the Treasury Department on hand to provide the administration viewpoint on the GAO report and the overall HIPC initiative.

Recently, I read over the Treasury Department's comments on the proposed modifications to the Enhanced HIPC initiative that were included in H.R. 1298, The United States Leadership Against HIV/AIDS, Tuberculosis and Malaria Act of 2003 (P.L. 108-25), that would link the amount of debt relief to debt service indicators, while placing a debt stock threshold of 10% on most countries, or a 5% threshold for those suffering from a public health crisis due to HIV/AIDS.

I was struck by the relatively meager level of funding required to make these modifications for the 26 countries that were analyzed, $1.3 billion according to Treasury. While it is true that the United States would likely bear the majority of the cost for this proposal, if we take the testimony of Tom Hart and DATA at face value, the actually cost to the U.S. could be as low as $26 million per year for 3 years. That $26 million a year would in turn help recipient countries save $430 million in debt service payments each year.

That seems to me like a very reasonable trade off, particularly when we are talking about countries like Zambia, Rwanda, and Mozambique, where life expectancy has dropped to below 40 years of age due to the HIV/AIDS pandemic.

How do you respond to the projections made by DATA, and why is the Treasury Department unwilling to even consider a limited application of the law given the expected financial savings for the recipient countries.

Question #2 (For Treasury Department)

As you know, I was a lead author and sponsor of the Global AIDS legislation that we enacted into law last year, and I am strongly supportive of expanding our bilateral programs to target assistance against this dreadful disease. But while I do believe that targeted assistance efforts to combat AIDS are very effective in reducing the spread of the disease and treating those who are infected, practical experience has shown that without the necessary infrastructure in place, rapid scale up of treatment programs becomes very difficult.

Would you agree that expanding debt reduction and elimination strategies for countries heavily affected by HIV/AIDS can in some cases dramatically improve the ability of heavily affected nations to build that infrastructure (given the proper direction from the World Bank)? Shouldn't we be pursuing policies that help these countries maximize the use of their own financial resources to build health care infrastructure and capacity (both physical and human), particularly when we are in the process of ramping up our bilateral global AIDS programs in these countries?

Hearing on HIPC Debt Relief
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
Committee on Financial Services
Rep. Maxine Waters
April 20, 2004

I would like to thank Chairman Oxley, Chairman King, Congressman Frank and Congresswoman Maloney for organizing this hearing on debt relief for heavily indebted poor countries.

During the 106th Congress, I worked with the international Jubilee coalitions and a bipartisan coalition of Members of Congress, including several members of this committee, to demand debt relief for the world's poorest countries. The purpose of our efforts was to free impoverished countries from the burden of their debts and, thereby, enable them to invest their resources in HIV/AIDS treatment and prevention, health care, education and poverty reduction programs.

In response to our efforts, the IMF, the World Bank and other bilateral and multilateral creditors developed the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative, which was supposed to reduce poor countries' debts to sustainable levels. The IMF defined sustainable levels of debt to be debts that did not exceed 150% of a country's total exports. In order to achieve this supposedly sustainable level of debt, the United States and other bilateral creditors agreed to cancel virtually all of the bilateral debts owed by poor countries. Unfortunately, the IMF and the World Bank refused to eliminate over half of these countries' debts. The report that the GAO is presenting today is an analysis of the progress of the HIPC Initiative.

The GAO report found that the HIPC Initiative failed to reduce poor countries' debts to levels that would remain sustainable through 2020 and still allow these countries to meet their economic growth targets. The GAO estimated that the 27 countries that qualified for debt relief could need more than $375 billion over the next 18 years in development assistance, export assistance and additional debt relief to enable them to achieve targeted levels of economic growth without exceeding the aforementioned debt-to-export ratio of 150%.

The conclusion that the HIPC Initiative was not a lasting solution to poor country debts did not come as a surprise to me, nor do I believe that it will come as a surprise to the dedicated activists of the international Jubilee coalitions. **My purpose in supporting debt relief for these poor countries was to achieve debt cancellation, not debt sustainability.**

Zambia provides an excellent illustration of why a strategy of "debt sustainability" does not lead to nearly enough poverty reduction or economic growth. Zambia is a deeply impoverished country with a per capita income of only $330 per year. Almost 20% of the adult population is infected with the AIDS virus, and 650,000 children have been orphaned by AIDS. Yet the IMF actually required Zambia to increase its annual debt service payments after reducing its total debt stock to 150% of its exports. Obviously, increasing Zambia's debt service payments is not a strategy that would enable Zambia to reduce poverty or achieve targeted levels of economic growth.

In February, 2003, I introduced **H.R. 643, The Debt Cancellation for the New Millennium Act**. This bill urged the President to negotiate with the IMF and the World Bank to completely cancel 100% of the debts that the world's poorest countries owe these institutions and give these countries a fresh start in the new millennium. This bill gained 45 cosponsors last year, but has not received any consideration in this committee.

The IMF can and should provide complete debt cancellation to poor countries using its own resources. In 2001, Drop the Debt, a jubilee affiliate, published a report that incorporated independent studies by two accountants and concluded that the IMF and the World Bank could afford to cancel 100% of HIPC debts without impeding their ability to function. These findings were reaffirmed last September in another report, which was published jointly by Jubilee Research of the United Kingdom and the Debt and Development Coalition Ireland. This report concluded that the IMF has enough resources to fund the cancellation of all of the $5 billion in additional debts owed to it by HIPCs and can also afford to cancel even more debts.

Shortly, I will be introducing the **Justice and Understanding By IMF Loan Elimination and Equity Act (JUBILEE Act)**. This legislation will require the IMF to cancel all of the debts owed to the IMF by the countries included in the HIPC Initiative as well as debts owed to the IMF by several other poor countries that need significant debt relief.

I hope all members of this subcommittee will support the JUBILEE Act. Complete debt cancellation is the only lasting solution to the problem of poor country debts.

HIPC Debt Relief: Which Way Forward?

Testimony for the House Subcommittee on Domestic and International Monetary Policy, Trade, and Technology April 20, 2004

Gerald F. Flood
Counselor, United States Conference of Catholic Bishops

I would like to thank the House Subcommittee on Domestic and International Monetary Policy, Trade, and Technology for the opportunity to testify here today. Debt relief for poor countries has been a high priority for the United States Catholic Bishops Conference (USCCB), and of our relief and development agency, Catholic Relief Services, for many years. In my testimony today I will be focusing on a number of issues at a level of technical detail which the bishops would not normally address, and on which they therefore would not have a position. Thus I offer my testimony primarily as a former development agency official who has worked on debt and related issues with both the World Bank and the USCCB over quite a few years.

Role of USCCB

But first let me briefly mention the very active role which the United States Catholic Bishops Conference has played in poor country debt relief. The bishops have issued two major statements on the issue, the first as far back as 1989. In the mid-90's the Conference intensified its work on debt, inspired particularly by the words of Pope John Paul II when he recalled the biblical tradition of the Jubilee Year. It was a time to restore social justice and equity between peoples, to give a fresh start to the poor. He called on all Christians, in the spirit of the Book of Leviticus, "to raise their voice on behalf of all the poor of the world, proposing the jubilee as an appropriate time to give thought, among other things, to reducing substantially, if not canceling outright, the international debt which seriously threatens the future of many nations."

In 1998 the Conference sponsored a major three-day meeting to examine the moral and ethical dimensions of the debt crisis. The gathering brought together senior representatives of almost every actor who has a role to play in international debt. They came from the United States, Europe, Africa, and Latin America--Church leaders, government officials, academics, heads of international financial institutions, private bankers, Catholic Relief Services and international and national non-governmental organizations. Informed and enriched by the 1998 meeting, the Bishops Conference issued a new Statement in 1999 which provides a moral rationale for debt relief as well as ethical criteria for debt relief programs.

Simultaneously with the preparation of the new Statement, the staff of the Bishops Conference and Catholic Relief Services engaged in intensive advocacy for debt relief with the US Administration and the Congress. We played an active role, along with many other US faith-based organizations, in the worldwide Jubilee 2000 campaign. During that campaign we had the pleasure of working closely with members and staff of the House Financial Services Committee, which provided strong leadership in responding to the call of the many poor countries around the world for relief from the heavy burden of international debt that was seriously affecting the lives and dignity of millions of vulnerable people.

The Financial Services Committee Played an Important Role

It was Rep. Jim Leach, then Chairman of this Committee, who back in 1999 took the initiative to introduce the comprehensive debt relief bill, H.R. 1095. Among the original co-sponsors who became strong

advocates for poor country debt relief were Reps. Spencer Bacchus, Barney Frank, and Maxine Waters. The bill attracted broad, bipartisan support, eventually some 140 co-sponsors. A companion bill was introduced in the Senate, and these two bills became a major vehicle for the dialogue of members of the US Jubilee 2000 movement with both the Congress and the Administration.

Of course, once the new program was adopted, it had to be funded, and once again it was members of this Committee who stepped to the fore. I will never forget the House floor debate on the Foreign Operations appropriations bill on a late summer night in the year 2000. Reps. Waters, Frank, Leach and Bachus all rose to speak movingly and forcefully about the importance of full funding for the HIPC program, and they were joined by quite a few others. And it was encouraging to hear speakers on both sides of the aisle talk about the responsibility of the United States to help the less fortunate around the world.

One of the most powerful statements was made by Spencer Bachus, who has spoken out frequently and eloquently about the moral imperative of debt relief. He put the issue into perspective: "[I]t is not a total solution to poverty, to hunger, to disease; but it is the first step. It is a necessary step. It is where the journey should begin to free these countries of the burden of debt, the chains of poverty, the shackles of despair, to enable them to minister to the economic and social needs of their people, their children." When the debate ended, the House voted to approve an amendment offered by Rep. Waters which tripled the appropriation for debt relief.

The Enhanced HIPC Program

While the Enhanced HIPC program, as finally adopted, did not provide the total cancellation of poor country debt which many in the Jubilee 2000 movement had called for, it was nevertheless a major advance over previous programs, promising much more debt relief, more rapidly, to many more countries. Moreover, at the time of the adoption of the new program, President Clinton announced that the US would go beyond the requirements of the program and cancel 100% of the debt owed to it by HIPC countries. Leaders of other creditor countries, including the United Kingdom, Canada, Italy, Australia and Denmark followed suit.

Also, the Enhanced HIPC program incorporated a new framework for the provision of debt relief and other external assistance to HIPC countries. This new approach, called the Poverty Reduction Strategy process (PRSP), contained elements that Catholic Relief Services, the bishops conference and many other non-governmental organizations had long advocated. The PRSP was intended to strengthen the poverty focus of development programs and to promote country ownership, transparency and civil society participation in their design and implementation. A major objective of these provisions, from our perspective, was to ensure participation of groups who could give voice to the needs of the poor, and who could help assure that the benefits of debt relief would reach the poor.

The Enhanced HIPC Program Has Now Been in Effect For Over Four Years. What Are the Results?

Debt Stock Reduction Is Substantial

As of the latest information available from the World Bank and the IMF, in 2002 NPV terms, about $51 billion in debt stock reduction has been committed to 27 countries, 23 of which are in Africa. (Another eleven countries, many afflicted by conflict, are potentially eligible for relief, but have not yet qualified).

Poverty-Reduction Expenditures Are Increasing

According to World Bank and IMF figures, debt reduction in the 27 countries is projected to free up about $1 billion annually in debt-service savings during 2001-2005. While accounting data that would permit tracking these savings to specific expenditures is not available, poverty-reducing expenditures as a whole in these countries increased by over $1 billion in 2001 and are projected by the World Bank and IMF to continue growing by over $1 billion a year through 2005. In other words, poverty reduction expenditures appear to be

increasing by more than the amount of the debt service savings. This is a hopeful sign that the poor are reaping the benefits of debt reduction.

Expenditure-Tracking Management Is Improving

In 2002, as part of the PRSP process, the World Bank and IMF assessed the public expenditure management systems of 24 HIPC countries and found that all needed upgrading to be able to track poverty-reducing expenditures satisfactorily. According to the World Bank and IMF, a more recent review examined country progress in implementing action plans developed to strengthen tracking capacity, and found that three-quarters of the measures in the action plans had either been implemented or are under implementation.

Unprecedented Civil Society Participation is Occurring

The PRSP process has facilitated an active role for civil society groups in the monitoring of expenditures for poverty reduction. While the record of progress varies from country to country, Catholic Relief Services reports impressive examples of civil society participation in a number of countries, including Bolivia, Uganda, Malawi and Zambia.

The Case of Zambia

Zambia is a good example. The HIPC Tracking and Monitoring Team of Zambia was established in 2001 by the Minister of Finance as an autonomous organization and consists of seven non-governmental organizations. Represented are a local Catholic Research and Advocacy organization, an NGO coordinating committee, and several professional associations composed of accountants, economists, procurement experts and marketing specialists. (An elaborate system has been set up in spite of the fact that the post-Decision Point debt service-to-revenue ratio dropped the least of any HIPC country.)

According to the Team's reports, the programs and projects supported by HIPC resources are derived from the PRSP and are incorporated in the annual budget. HIPC-related expenditures are identifiable in all budgetary procedures. Over the past year and a half the Team has completed comprehensive, highly detailed reports on the use of HIPC resources in four major regions of the country. The report on the Copperbelt Province was based on physical inspections and financial audits in all provinces and districts which received funds. The report is frank and hard-hitting and contains highly specific findings and recommendations concerning wasteful and inefficient practices and inadequacies in implementation capacity as well as instances of misapplication of funds.

The Team's bottom line is that the HIPC funds disbursed between 2001 and 2003 in the Copperbelt Province had on average a positive impact on the poverty of the people. Expenditures were especially beneficial in health, education, water and sanitation. In other areas (road rehabilitation, forestry, land resettlement and social welfare), the impact had been below expectation as the resources disbursed had been misapplied or abused. The effectiveness of the monitoring system will depend on whether, and how well, the authorities act to correct the deficiencies.

The Case of Malawi

An equally impressive example can be found in Malawi. Catholic Relief Services reports that local civil society organizations came together to form a federation called the Malawi Economic Justice Network (MEJN). Once HIPC funds were granted, they worked closely with the Parliamentary Budget and Finance Committee to identify twelve key categories of priority poverty expenditures in the 2001-2002 budget. They persuaded the Malawi Ministry of Finance to produce periodic expenditure figures for each of these categories and worked with the Parliamentary Budget and Finance Committee to monitor the allocation of funds to the relevant line ministries.

The MEJN formed three sub-groups in the sectors of health, education and agriculture to monitor the delivery of services. They selected dozens of local districts and provided three- to five-day training to local

leaders in the use of survey instruments. Local leaders used questionnaires to discover, for example, whether clinics had medicines, schools had books, and teachers were trained. The data was compiled and analyzed by experts, then used to publicize such findings as – (1) government spending on vital medicines for health clinics was 50 percent short of its commitment, (2) despite a 221 percent increase in spending on teaching materials, 41% of schools had not received any new materials during the first six months of the budget year, and (3) off-budget teacher salary increases of 68 percent had been approved.

The survey results were shared first with communities, then with the government, donors and other stakeholders. The MEJN developed a strategy to disseminate the results via radio, newspaper, and paid ads, and also used them to lobby Members of Parliament before their deliberations on the budget.

The monitoring exercise appears to have had a positive impact. For example, the national budget was recently revised, adding items such as salary increases, and shifting allocations from some non-priority items (foreign travel, expenditures of the office of President, etc.) to priority poverty programs. The Ministry of Education is using the findings in its own planning, and Parliament is using them to question the line ministries.

The broader point in the Malawi and Zambia examples is that the procedures instituted with the enhanced HIPC debt relief program appear to be making a contribution to the strengthening of democratic processes in a number of countries where historically weak governance has often led to serious neglect of the needs of the large majority of very poor and vulnerable citizens.

<u>Unanticipated New Borrowing Is Not Occurring</u>

The fears of debt relief critics -- that once HIPC countries received debt relief they would resume earlier patterns of irresponsible borrowing-- appear to be unfounded. The World Bank and the IMF recently did an analysis of the 27 HIPC countries which have passed their Decision Point to determine which ones were likely to have debt in excess of HIPC thresholds (mainly debt stocks above 150 percent of exports) at the completion point. They found that after full HIPC relief, nine countries would still have debt above the HIPC thresholds. In examining why this was occurring, they observed that it was not the result of unanticipated new borrowing. In fact, the nine HIPCS had borrowed slightly less than anticipated. What was driving the key debt ratios above HIPC thresholds was exogenous factors: the depreciation of the US dollar, the decline in the discount rate because of declining market interest rates, and a decline in export earnings. One of the lessons of this experience is the importance of making the HIPC debt relief deep enough to provide an ample cushion against events over which they have no control.

<u>Additionality Is Occurring—for the HIPCs</u>

Finally, there is the question of additionality. One concern had always been that donors might offset the cost of HIPC by reducing their aid programs by an equivalent amount, leaving the HIPC countries no better off than before. The good news is that this apparently is not happening. The latest HIPC progress report shows that net resource flows to the 27 HIPC beneficiaries have increased substantially since they began receiving HIPC relief. There are some down sides to the picture, however. First, official flows to these countries declined substantially in the mid-90's. Thus the recent increases only restore external aid to the levels of the early 90's. Second, according to the World Bank's Operations Evaluation Department, the downward trend in aid which occurred in non-HIPC countries has not been reversed, at least not through the year 2000. If this means that HIPC relief is coming at the expense of assistance to countries which have perhaps managed their external finances better than the HIPC countries, it is a disturbing development. It highlights the importance of making sure that important new aid initiatives such as the Millennium Challenge Account and the 2003 HIV/AIDS Act are additional to existing funding for core development accounts.

What are the problems or deficiencies in HIPC implementation?

Progress Toward the Completion Point Has Been Slow

There are a number of concerns with how the HIPC program is being implemented. In the first place, HIPC is in its fifth year yet only 11 of the 27 HIPC beneficiaries have reached their Completion Point. There are a variety of reasons for this, but, under the HIPC, rules it means that the majority of the HIPC countries are unable to receive more than one-third of their committed debt relief.

Zambia is a case in point. My understanding is that the completion point is being held up because pressures to increase salaries led to an overshooting of the wage bill target agreed with the IMF. The salary increases resulted from contracts negotiated with public employee labor unions last year. The World Bank examined the wage bill problem as part of a comprehensive report published last November and entitled "Zambia Public Expenditure Management and Financial Accountability Review." It says:

> Even with excellent policies and procedures, sound financial management would be difficult to achieve without properly motivated and skilled staff. Low remuneration in the public sector is a major factor contributing to the problem of poor productivity, motivation and recruitment and retention. At a time when government is seeking efficiency improvements, in part by reducing the size of the civil service, there exist significant staff shortages in a wide range of professional and technical jobs owing to poor pay compared to that available in the private sector and within regional labor markets.
>
> The real wages for civil servants has declined since the mid-1970's. While this decline to some degree mirrors the overall macroeconomic decline of the country, real public service pay declined much faster than did real GDP per capita from 1975 to 2000....
>
> The problem of low pay ... notwithstanding, the wage bill in Zambia has remained large relative to overall government expenditures, thereby crowding-out operational expenditures. The challenge for Zambia is therefore how to design and implement a pay reform strategy that is consistent with the macroeconomic goal of containing the size of the wage bill (as a proportion of GDP).

The World Bank report outlines a broad strategy for addressing the issue, but the challenge is an enormous one– how to make wages sufficiently remunerative to attract as well as retain qualified staff while at the same time minimizing the cost. It is difficult to see how it can be dealt with effectively except, at best, over the medium term. In the meantime, Zambia continues to be plagued by a heavy burden of past debt. In fact, the fiscal bind which Zambia finds itself in can be attributed in large measure to its heavy debt service obligations. According to the projections in the latest IMF and World Bank status report, Zambia's debt service will be an extremely high 31 percent of government revenues in 2004.

Paraphrasing Spencer Bachus, debt relief is not a panacea. It will take much more than debt relief for the HIPC countries to emerge from poverty. But by delaying full debt relief, it is restricting the ability of HIPC countries to create the kind of fiscal space so important for moving ahead to address in a more effective way the human needs of their people. The IMF and World Bank should reexamine the conditions for reaching the Completion Point, particularly those that are unrelated to assuring that the debt relief savings will reach the poor. In doing so, they should take into consideration that they have continuing relationships with all these countries and that economic performance concerns can be addressed in the context of new lending.

The Amount of Committed Debt Relief Is Uneven

I would also like to highlight two other concerns. The first has to do with the amount of the relief being offered. As you know, the amount of debt reduction provided under the program is measured primarily in terms of the relation between debt stock and exports. What is most important, however, is the relation between debt service and government revenues. When we examined the first figures published by the IMF and World Bank

after the initial 22 countries qualified for relief, we wanted to know how much government revenue would be freed up for expenditures in education, health, clean water, rural roads and other investments that would create opportunities for the millions living on less than $2 a day to break out of the cycle of poverty and begin to achieve their human potential. Unfortunately, what we found was a wide variance in the amount of debt service reduction being granted. For one or two countries, the debt service obligation was being brought down to around 5 percent of government revenues. For most of the remaining countries, however, this ratio was substantially higher and in several cases remained above 20%. This was disappointing news as what was important was to provide debt relief deep enough to give a "fresh start" to the poor. Moreover, the results seemed inconsistent with the Communiqué issued by the G-8 leaders when at the 1999 Summit in Cologne, Germany. In announcing the new program, they succinctly stated: "The central objective of this initiative is to provide a greater focus on poverty reduction by releasing resources for investment in health, education and social needs."

To correct this problem, the HIPC formula should be revised in line with the original provisions of HR 1095, so that no country would have to pay more than 10 percent of government revenues in debt service. Moreover, many of the countries heavily burdened with external debt are being devastated by the HIV/AIDS pandemic. Thus, for countries suffering from a public health crisis, measured in terms of the incidence of HIV/AIDS, the debt service- to-revenue ratio should be reduced to no more than 5 percent.

Thanks to the leadership of Sens. Santorum and Biden in the Senate and Rep. Chris Smith and members of this Committee in the House, an amendment was inserted in the 2003 HIV/AIDS Act which incorporated the essence of the 5 and 10 percent proposal, while allowing flexibility to adopt other formulas such as debt service to GDP, as long as it produced substantially the same result. Unfortunately, the Administration has treated the language of the amendment as advisory and has not initiated the international consultations necessary to bring about a revision in the HIPC criteria. We are hopeful that with the aid of the many Congressional supporters of debt relief, the Administration can be encouraged to start the consultations.

HIPC Goals Cannot Be Achieved Unless the Financing Gap Is Filled

This brings me to the other main concern. Part of the reluctance to move forward arises because of the shortfall in the amounts necessary to finance the existing HIPC program, a topic that is reviewed in the GAO report, *Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*. It would be devastating to the HIPC beneficiaries to contemplate the possibility of receiving anything less than the full debt relief promised under the existing program because of funding shortfalls, or to see it blocking any possibility of increasing the amount of the relief.

It is very important, therefore, to examine how substantial this issue really is. The analysis of the GAO report is presented in terms largely of net present value (NPV). This is the discounted sum of amounts required over a period of 16 years to write off debt service as it becomes due. I think it is important also to convert the NPV into annual requirements, because this will show the actual budgetary impact from year to year. I have tried to make some rough estimates of what this impact might be, and if my figures are anywhere close to being accurate, the issue should be much more manageable than it may seem The shortfall has several components, and, because of the importance of the issue, I would like to address each one separately.

The first shortfall is in the HIPC Trust Fund, which finances part of the HIPC costs of regional multilateral banks such as the African Development Bank. A shortfall of $650 million was identified some time back, and the major donor countries agreed to cover it. The US needs to provide $75 million to complete its agreed share of this shortfall. The President's request to include this amount in the FY05 budget should be approved. The GAO report says that a gap in HIPC Trust fund financing will emerge several years from now. I am not clear whether any portion of this gap would be covered by the $650 million which the creditors have already agreed to provide. Assuming it is not, the US share of this gap, according to the GAO, could be an additional $130 to $350 million. However, these funds would not be needed until 2008 and would be required over a ten-year period. Thus, the annual cost to the US would be very small: $13 to $35 million per year.

The Inter-American Development Bank apparently does not have a financing gap. However, the GAO report indicates that this is being accomplished by a planned $600 million reduction in their projected lending during 2009 to 2013 to countries eligible for their concessional window, the Fund for Special Operations (FSO). This suggests that funding for HIPC will come at the expense of the poorest countries in Latin America and the Caribbean. It would be important to assure that this does not happen. The first point to make is that one must deal with many uncertainties in trying to project lending needs five to ten years from now. Thus the $600 million figure must be regarded as highly tentative. Moreover, if the $600 million does become a firm figure, it breaks down to $120 million on an annual basis. The IDB is a strongly capitalized institution with a large portfolio and no non-performing loans. In 2003 alone, it disbursed $8.9 billion. In this context, and assuming appropriate advance planning, finding another $120 million in 2009 for the FSO countries would not seem to present a major hurdle, especially if IDB gives appropriate priority to its poorer members. If it does become necessary to turn to the shareholders, one alternative might be to finance a portion of the shortfall through the HIPC Trust Fund, in which case the maximum annual US share might not exceed about $25 million.

The Largest Shortfall Is in the IDA Component

The largest shortfall in HIPC financing is in the IDA component. According to the GAO report, the IDA gap is estimated at $6.5 billion. This translates into a need for about $584 million on average through 2020. The main point I would make is that this gap assumes that the IBRD would cease net income transfers to IDA for HIPC debt relief after 2005. These transfers have been made at a rate of about $240 million a year. To my knowledge these transfers have had no significant impact on the World Bank's financial situation, and it would seem that a viable option would be to continue to make income transfers at least at the current level. I am not privy to the World Bank's financial projections and priorities, but I note from its recent Annual Report that the $240 million allocated to HIPC last year was taken from total allocable net income of $3.05 billion. The HIPC allocation still allowed $2.4 billion to be added to general reserves, continuing the upward trend which has led to an increase in the World Bank's equity (excluding callable capital) of 43% since 1998 and has brought the ratio of usable equity to loans up to 25%.

If IBRD net income transfers continue at the rate of $240 million a year, this would lower the average annual gap to around $345 million. If the US were to contribute 20% of this shortfall, the annual requirement would be about $70 million, or $210 million per replenishment.

Other Gaps May Arise in the Future

Another gap in the existing program arises from the fact that four countries potentially eligible for HIPC relief, i.e., Laos, Liberia, Somalia and Sudan, have not been included in the World Bank/IMF costing exercise. The World Bank's preliminary estimate is that the net present value of the cost of HIPC debt reduction in these countries would be in the range of $10 billion. These estimates are highly tentative, as pointed out in the GAO report, and they may be understated. The bulk of the costs relate to the Sudan, which would create substantial costs for the US. This is because the US would be committed to canceling Sudan's substantial US bilateral debt, as well as contributing to a portion of multilateral costs. However, Sudan is embroiled in internal conflict and has major governance problems, so it seems unlikely that it would qualify for HIPC relief anytime in the near future. The timing of possible debt relief for the other three countries is also highly uncertain.

Topping Up Needs To Be Financed

The final funding shortfall is related to the provision in the enhanced HIPC program for "topping up" debt relief at the Completion Point for countries who have experienced exceptional exogenous shocks "that cause a fundamental change" in a HIPC country's economic circumstances. It hasn't been clear how this language would be interpreted. However, the World Bank and the IMF have made an estimate of topping up costs. They say that because primarily of movements in exchange rates, changes in discount rates, and declines in commodity prices, about seven to nine countries would qualify for topping up. They recently updated the cost

estimate. It is now $1.8 billion with almost one-half attributable to Ethiopia and Niger. The IDA share of this cost is $1 billion.

According to press reports a few days ago, agreement has been reached among the major creditors, after reportedly stiff opposition from the US and Germany, to provide Ethiopia and Niger with $800 million in "topping up" relief. I do not know what kind of burden sharing has been agreed, but it would seem reasonable for the World Bank to finance a substantial share of its costs–one option might be 50 percent (or $500 million)—from it own resources. On this basis, and otherwise using normal HIPC burden sharing arrangements, the US share of the remaining $1.3 billion over 16 years might be around $20 million annually.

The US Contribution to the HIPC Shortfall, Which Should Be Manageable, Is Essential to Achieving HIPC Goals

By adding up the numbers emerging from the alternatives I have suggested, I have come up with an estimate of the overall cost of filling the gaps in the various components (excluding Sudan and the other uncertain countries). Time has not permitted a deeper analysis or a careful vetting of these numbers, but in any event, my rough estimate of the average amount that would have to be budgeted on an annual basis for 2005 through 2008, is $150 million. Obviously the GAO calculation is different, and there may be other options that should be considered, but the United States has made a heavy commitment to the success of the HIPC program and the additional amount required should be manageable, even in a period of budget stringency. Past experience shows that other creditors will only act when the US does. It is, therefore, critical to the the achievement of the goals of HIPC that the US exercise leadership and commits its fair share of the shortfall.

The above estimates do not include the incremental cost of implementing the 5-10 percent provisions included in the HIV/AIDS law. The Treasury Department made an estimate of this cost in its October 2003 Report to Congress on Proposed Modifications to the HIPC Initiative, H.R. 1298. The total for the three-year period 2003-2005 comes to $1,284 million. The average annual cost is $428 million. The figures are not broken down, so it is not possible to determine what portion of the cost would fall on the US. However, under existing HIPC burden sharing arrangements, the US would be expected to pay a share of the costs of the African Development Bank and other regional multilateral banks receiving financial assistance through the HIPC Trust Fund. A very rough estimate of the share of the regional banks in the total cost is 30 to 35 percent. Applying the assumptions used in the GAO report, the annual US contribution to the HIPC Trust Fund would be between $15 million and $40 million, a very modest amount in US budgetary terms. The US might also be asked to contribute to a portion of the IDA share of the costs, but this should add only about $10 million to US costs.

Achieving Poverty Reduction Goals Requires a Comprehensive Approach

The GAO Report makes the very important point that even if the HIPC program is fully financed, substantial additional external assistance will be required to enable HIPC countries to achieve growth and poverty reduction targets. Debt relief is not a panacea. Even if the debt of HIPC countries is reduced to zero, it will not end poverty. The problem is too complex and deep-seated for that. It must be addressed first and foremost by the countries themselves, with their governments and people working together on a variety of fronts for the common good. But they are too poor to do it alone. They need aid and support from the wealthier countries.

The GAO has made estimates of the amount of external assistance required through 2020 for the 27 HIPC qualifiers to achieve growth and poverty reduction targets. One can certainly raise questions about the numbers. I would like to know, for example, to what extent the $153 billion in what is called "expected development assistance" reflects current assistance trends or implies a step-up in foreign aid. Also to what extent are these amounts consistent with what development experts have estimated as necessary to achieve important Millennium Development Goals? With respect to the export projections, there are ample grounds for

believing that the World Bank and IMF projections are too optimistic, and I am happy to note that the World Bank seems to agree that it needs to make them more realistic. At the same time, is it not too pessimistic to take the historical data as the most likely indicator of future performance? The time horizon used is 18 years, and I remain hopeful that ongoing efforts to improve development efforts in many of the HIPC countries will yield sufficient progress over this span of time to reduce export volatility.

Moreover, in the strategy it lays out for dealing with the expected export shortfall, the GAO assumes that it would be addressed entirely through additional aid. This overlooks an important dimension: external trade. Countries can achieve substantial economic benefits by more open trade, provided it is also fair trade. The World Bank estimates that trade barriers in Europe, the United States and Japan cost poor nations more than $100 billion per year.

Longer-Term Approaches Are Needed To Protect Against Future Debt Crises in Poor Countries

. There is one part of the GAO analysis that I think warrants particular attention. This is the discussion of post-HIPC forms of debt relief. The debt relief provided by HIPC is no guarantee that the countries will avoid serious debt servicing difficulties in the future, no matter how much their debt management improves. Low income countries are particularly susceptible to exogenous shocks, whether from financial or product markets or from natural phenomena, and they cannot count on repeated HIPC-type debt reduction exercises. The topping up exercise implicitly recognizes this problem, but it does not provide relief beyond the completion point. Nancy Birdsall and John Williamson of the Center for Global Development propose one method of dealing with this in their book, *Delivering on Debt Relief*. They recommend safeguarding countries, through a ten-year contingency facility, against being pushed back into unsustainable debt levels by circumstances beyond their control.

Birdsall and Williamson also endorse the suggestion made by President Bush in 2001 that IDA should convert about half of its loans into grants. In fact, IDA is already moving in this direction in the on-going IDA 13. It expects that 18-21 percent of its development assistance during 2003 through 2005 will be delivered in the form of grants. The GAO outlines a similar strategy in its report and estimates that almost all the 27 HIPC countries could achieve debt sustainability if multilateral creditors converted an average of one-third of their new loans to grants. Their cost estimate for this conversion is $8.5 billion. I have not examined the assumptions underlying these estimates, and I am not clear, for example, how they define "debt sustainability," but I support the general thrust of this strategy.

In fact, the Catholic Bishops Conference supported the expansion of IDA's grant authority in IDA 13. However, they also emphasized the importance of early consideration of the implications of the conversion on the financial situation of IDA. Currently internal sources, primarily reflows from past lending, account for roughly 40 percent of IDA's commitment authority. If these reflows are seriously depleted, it could cause IDA to sharply scale down its lending to the world's poorest countries. It is true that the loss of reflows would only begin to affect IDA's finances after the ten year grace period on their loans, but, after that, losses would begin to mount rapidly. At the time of the IDA 13 negotiations, the World Bank calculated that if donors were to begin making contributions immediately, the total contribution from all donors would be $400 million (presumably $80 million from the US) during IDA 13. If, however, they chose to wait, the required contributions would rise sharply. Unfortunately, to my knowledge, the US and most of the other donors have chosen to wait. The matter will require urgent attention in the IDA 14 consultations which have recently begun.

debt AIDS trade africa

Statement of

Thomas H. Hart
Director of Government Relations
DATA – Debt AIDS Trade Africa

"Debt Relief for the Poorest Countries:
Accomplishments and Ways Forward"

Hearing of the

Subcommittee on Domestic and International Monetary Policy,
Trade, and Technology

of the

Committee on Financial Services
U.S. House of Representatives

April 20, 2004

Mr. Chairman, Ranking Member Maloney, members of the subcommittee, I appreciate the opportunity to share the views of my organization DATA – Debt, AIDS, Trade, Africa – on the important issue of debt relief for the poorest countries.

While DATA is a relatively new organization, we are probably best known by our co-founder, Bono, lead singer of the Irish rock band U2. Bono has been a champion of fighting AIDS and poverty in Africa for many years. He and many of the people who now make up DATA's staff – myself included – began this work as part of the Jubilee 2000 debt relief campaign several years ago. That global campaign helped instigate the current debt relief program, the Enhanced Heavily Indebted Poor Country (HIPC) Initiative, that you are considering today.

The Enhanced HIPC program got its launch in the United States from the leadership of this subcommittee and full committee at the time. I want to thank Mr. Leach, Mr. Bachus, Mr. Frank, and Ms. Waters, as well as many others, who led the legislative effort, along with the Clinton Administration and then-candidate Bush, to push the global agreement to provide debt relief. Your legislation provided the essential authorizing framework and the political momentum to approve the new program and get it funded. Given that history – perhaps parentage – this Subcommittee is taking an appropriate look at what has been accomplished, what problems exist, and what steps might be taken in the future. Having been here 5 years ago at this program's creation, I am honored to bring you my perspective on these important issues.

Congress and the Administration should be applauded for supporting the HIPC initiative. For an investment of under $1 billion spread over several years, the U.S. has leveraged $30 billion from other donors, writing off $50 billion worth of debt stock – a significant "clearing of the books" of decades-old debt, providing a fresh start to these countries. It also freed up $1 billion a year in debt service for 27 of the poorest countries that are now building schools, clean water wells and AIDS prevention programs with this money. It has not, however, provided a lasting solution to the debt crisis and could be improved.

Debt Relief – Essential but Not Sufficient

Debt relief is not, nor was it ever intended to be, a panacea for its recipient countries. While its benefits are real, debt relief is only part of a comprehensive development strategy to help poor countries reach poverty reduction and development goals. Shifting from loans to grants, additional and effective development assistance, as well as better trade terms are all critical to poor countries. Debt relief, and even 100% debt cancellation, cannot address all the problems of needy countries. Debt relief is a first, critical, but not sufficient step.

Background

Over the last several decades, poor countries accumulated large international debts, built up through Cold War-motivated lending, natural disasters, as well as decisions by corrupt dictators. These debts became a serious impediment to poverty reduction and economic development in the world's poorest countries. Many poor countries spent 30-40 percent of their annual budgets paying back decades-old debts, much more than they spent on health and education combined.

Worse yet, most borrowed more money in order to cover their payments on old debt, creating a vicious cycle of indebtedness.

In 1996, the World Bank, IMF, and their member governments agreed to provide debt relief to approximately 40 of the world's poorest and most indebted nations. The first HIPC Initiative was designed to cancel some bilateral and multilateral debt for eligible countries in order to reduce their external debt burdens to "sustainable" levels.

After adopting IMF and World Bank supported economic and governance reform programs for three years, poor countries could receive relief on debt service payments. Then, if reforms continued, they would become eligible for cancellation of some debt stock. Under this 1996 plan, only 7 countries qualified for debt service relief with few resources freed for poverty reduction and development.

Then, under the banner of "Jubilee 2000," the religious community and other advocates around the world raised the concern that crushing debt burdens continued to push the poorest countries deeper into poverty, diverting scarce resources from health, education, and other development needs. This movement united under a call for deeper, faster and broader debt relief for the poorest countries, through a fair and transparent process to correctly balance in the interests of creditors and debtors. Campaigns emerged in more than 60 countries, and inspired support from numerous luminaries such as Pope John Paul II, Billy Graham, Desmond Tutu, Pat Robertson, Muhammad Ali, and of course Bono. But the real heroes and inspiration for this movement were the grassroots groups and anti-corruption campaigner in the Global South – like the Uganda Debt Network – who called upon the developed world to do more, and who monitor the ongoing use of funds released by HIPC.

In response, the G7 and then the Boards of the World Bank and IMF adopted the "Enhanced HIPC Initiative" in 1999. It was designed to provide deeper debt relief for more countries more quickly, and more directly tie the provision of debt relief to country-led poverty reduction plans. The agreement obligated each creditor government to (a) write off its own bilateral loans to qualified poor countries, (b) authorize the IMF to use internal gold resources to write down its loans, (c) contribute to a pool of funds to write off multilateral debts, and (d) approve a new process for debt relief and new lending at the World Bank and IMF that had poverty reduction as its focus, not economic austerity programs.

Congress, led by this Committee, provided essential authorizing legislation and appropriations allowing the U.S. to participate in this initiative – which triggered other countries' participation – in the fall of 2000.

Between fiscal years 2000 and 2004, Congress appropriated $860 million to fund the Enhanced HIPC initiative in both bilateral debt relief and contributions to cut multilateral debt.

Progress and Impact

Since 2000, 27 poor countries have qualified for the HIPC program – all but four of them are in sub-Saharan Africa (country list attached). The benefits of this program for these 27 countries have been measurable.

Reducing "debt overhang" – Upon completion of the program, these countries will see their debt stock reduced by two-thirds, cutting $52 billion in nominal terms[1]. Getting rid of this "debt overhang" reduces a strong incentive for capital flight. The average amount governments actually have to spend on debt service has gone from 25% of their budgets to 15%.

Civil Society and Transparency – An important part of the HIPC program has been the inclusion of civil society and greater government transparency in the creation of country poverty reduction plans. Recipient governments must engage in a broadly participatory consultation process with civil society, business, labor, academic, religious and others to determine the poverty reduction priorities for the country. This Poverty Reduction Strategy Paper (PRSP) process has not been perfect, to be sure, but still represents a significant new approach to improving country ownership by non-government actors, as well as enhancing transparency.

Debt Service to Poverty Reduction – One of the conditions for receiving debt relief was the recipient government's agreement to use the debt service savings for poverty reduction. More than $1 billion annually in debt service is now staying in these 27 countries to fight poverty. Evidence collected by the World Bank shows that, indeed, recipient countries are using this $1 billion in the ways intended – in fact expenditures on poverty reduction in these countries has risen by nearly twice that amount. By another measure, spending on poverty reduction as a share of total government spending rose from 41% to 54% (1998-2004). And spending on military in these countries has risen by only an inflationary 2% in this time.

According to research conducted by Jubilee USA Network, the successor organization to the U.S. chapter of Jubilee 2000, this debt relief is working on the ground to help people's lives (paper attached).

- Tanzania has used its savings from debt relief, averaging around $80 million a year, to increase education spending and eliminate school fees. An estimated 1.6 million children have returned to school.
- Uganda used the bulk of debt relief savings to fund universal primary education, more than doubling the school enrollment rate to 94%, which has contributed to Uganda's remarkable decline in HIV rates. It also dug many clean water wells.
- Mozambique has used substantial debt savings of around $70 million annually to vaccinate children against tetanus, whooping cough and diphtheria, as well as to build and electrify schools.
- Cameroon's $140 million per year savings were used to launch a national HIV/AIDS plan for prevention, education, testing, and mother-to-child transmission abatement.

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1 Unless otherwise noted, numeric data comes from World Bank/IMF "Heavily Indebted Poor Country Initiative - Status of Implementation," September 12, 2003.

Room for Improvement

While the Enhanced HIPC initiative is a significant step forward in reducing unpayable debt stock and freeing up some resources for poverty reduction, more needs to be done.

1. *Uneven results* – The impact on recipient countries in terms of debt service has been very uneven. Currently Burkina Faso is the only one of the 27 countries that spends less than 5% of revenues servicing debt. 19 of these countries spend more than 10%. The Gambia spent around 35% of revenues servicing debt in 2003.

2. *Remaining debt* – Much of the progress to date has been to eliminate large chunks of old debt stock – the "debt overhang" – which was not being paid back. To a smaller extent the HIPC program, as noted above, freed up money for poverty reduction. Unfortunately, the 27 currently qualified HIPCs continue to pay $2.3 billion annually on debt service, with the World Bank and IMF as the two largest remaining creditors. These are badly needed resources that could address major crises facing their nations, including fighting poverty, preventing HIV/AIDS, rebuilding infrastructure and putting children into school.

3. *Debt sustainability* – The Enhanced HIPC Initiative does not provide a credible guarantee that these countries will reach or maintain "debt sustainability," the purported objective of the program. Currently, debt sustainability is defined as reaching 150% of debt stock to exports. HIPCs graduating from the program are struggling to reach the 150% debt/export ratio, and there is little expectation they will maintain that level. The World Bank's own analysis concludes that in order for HIPCs to be sustainable under the current program, countries would have to grow at almost 8% a year, twice the rate as they did over the last 20 years. Also, because the current program is tied to exports, shocks to commodity prices have had a severely negative impact on many countries' debt sustainability. Such was the case for Niger, which recently was approved to have its debt relief "topped up" so that it could graduate the HIPC program within the 150% limit.

   Ethiopia also is nearing its graduation above the 150% threshold due to shifting global interest rates. While not an "exogenous shock" that the HIPC program fully anticipated, the World Bank has found that the impact has made it harder for Ethiopia to maintain debt sustainability and recommends it receive greater relief.

4. *Process and Conditions* – The HIPC program's biggest structural weakness is the process continues to be driven and controlled by creditors. In a domestic bankruptcy procedure, courts usually balance the interest of creditors with basic needs and financial capacity of debtors to arrange a suitable outcome. No such disinterested party exists in the HIPC program. One of the concrete results of this imbalance is some of the conditions associated with debt relief have been harmful to the goals of poverty reduction – such as the imposition of user fees on education, health, water, and sanitation.

5. *More countries* – More poor countries could benefit from both bilateral and multilateral debt reduction, in the same way the current 27 HIPC-qualified countries have. The original HIPC

framework identified 42 heavily-indebted poor countries, and this list did not include Nigeria, Haiti, Bangladesh, Kenya, or many others that could benefit. As we have seen recently in Iraq, any reconstruction and development package should include substantial debt relief as a way of easing the financial pressure on a burdened country and freeing up resources to meet critical needs.

Debt Legislation

Over the last couple of years, DATA and a broad coalition of churches and other NGOs have supported an effort to address the first 4 of these shortfalls, by changing the way debt relief is measured for the qualified HIPCs. With the leadership of Mr. Frank and Mr. Smith of New Jersey here in the House, and Senators Santorum and Biden in the Senate, legislation was introduced to make a simple change to the Enhanced HIPC initiative to free up additional debt service and lead to greater debt sustainability. This legislation was enacted into law last year as part of the global HIV/AIDS bill, Public Law 108-25.

The legislation urged the Administration to negotiate with international partners a change to the HIPC program. Instead of defining the goal of debt sustainability as simply 150% debt stock to exports, the legislation proposed that countries should pay no more than 10% of annual government revenue on debt service and, in the case of a country hard hit by a health crisis such as HIV/AIDS, no more than 5% of revenue. The majority of the 27 HIPCs would qualify for the 5% health crisis level. Adding this debt service-to-revenue formula would more closely link debt relief to a countries ability to pay, and limit some of the volatility that changing exports have had on current debt sustainability measures.

Also, such a change would lower overall debt levels. Comparing apples to apples, under the current system, the 27 HIPCs pay an average of 15% of their budgets on debt service. The legislation would reduce this level to 5 or 10 percent.

The Department of the Treasury's estimate of the cost of this proposal is roughly $1.3 billion over 3 years to all creditors (Treasury's report to Congress on this proposal is attached). Data to assess the costs to the U.S taxpayer are not readily available. However, if the same financing mechanism used currently is applied to this proposal, the cost to the U.S. could be as low as $26 million per year for 3 years[2]. For recipient countries, this would result in an additional debt service savings of $430 million each year, increasing by nearly 50% the amount of resources freed up from debt service for poverty reduction. Therefore, with a modest increase in expense to the program, we could dramatically increase its impact on poor countries.

The Administration expressed concern with draft versions of the legislation about the debt service-to-revenue formula. In response, Congressional sponsors authorized Treasury to come up

2 Under the current HIPC program, bilateral creditors like the U.S. cover the costs of their own bilateral loans and contribute to writing down non-World Bank/IMF multilateral debt (mostly regional multilateral banks). Since the U.S. has no remaining bilateral loans to the 27 HIPCs, and the World Bank and IMF would cover their share of the costs, the U.S. would contribute a portion (20% under the current program) to write down regional banks' debt. This non-World Bank/IMF multilateral debt is assumed (based on an estimate of the composition of remaining debt to the 27 HIPCs) to be approximately 30% of the total, or $385 million of the $1,284 million cost. A 20% U.S. share of this is $77 million over 3 years, or $26 million/year.

with a similar formula or mechanism that would accomplish the same goals of deeper relief for qualified HIPCs. For simplicity, the legislation is designed to operate within the existing structure of the HIPC program – it does not seek to expand the number of countries (although it requests a report on the feasibility of expansion), and it does not change the basic rules or financing of the program.

Despite this legislation being law for nearly a year, the Administration has not pursued negotiations with international partners to implement its provisions.

Additional Debt Relief Proposals

In addition to the change already in law, the Subcommittee might consider additional proposals for deeper and broader debt relief:

1. *Cancel 100% of debts to the World Bank and IMF* – Because several major bilateral donors (led by the United States) have written off 100% of their debts to HIPCs, the World Bank and IMF could do the same from their own resources. To finance the IMF's share of the current HIPC program, the IMF revalued its gold holding and used the interest from the proceeds to write off HIPC loans. The World Bank used a portion of its substantial annual net profits to help write off HIPC debts. Such holdings could be used to expand their own debt write-offs.

2. *Debt-for-AIDS conversion* – As the world mobilizes resources to fight the crisis of HIV/AIDS, debt conversions could be considered. Essentially, an agreement would be reached that a recipient country take all or a portion of its annual debt service payments and commit those to fighting AIDS. This could be done bilaterally or to support programs through the Global Fund to Fight HIV/AIDS, TB and Malaria.

3. *Debtor-creditor process and conditions* – Congress has and should continue to review IMF and World Bank structural adjustment conditionality to ensure conditions are not harmful to the goals of poverty reduction and sustainable development. Independent arbitration mechanisms should be considered to fairly balance the competing interests of debtors and creditors.

Funding Shortfalls in the Current Program

Both the Administration and General Accounting Office raise concerns about the funding shortfall for the current program. This shortfall is a key reason cited for not pursuing changes like the new debt legislation discussed above. But these funding challenges can be met.

1. There is a $650 million shortfall in the HIPC Trust Fund to cover the costs of the expected 33 countries that will qualify. This "shortfall," however, is not a surprise and the Congress has already appropriated half of the $150 million the U.S. has agreed to cover of this amount, and is likely to fund the other half in the 2005 budget.

2. The other major funding gap is to reimburse the World Bank's IDA program for its debt relief. GAO estimates this may cost $6 billion from 2006-2020. The solution is to ask the World Bank to continue to do what it has done for the first 5 years of the HIPC program – take a portion of its substantial annual profits to pay for its share of HIPC debt relief. According to annual reports, the World Bank has transferred $200-300 million annually from net profits to the HIPC Trust Fund. But it plans to stop at the end of 2005 – thus the massive funding shortfall from 2006 to 2020.

3. Another large asset exists at the IMF – millions of ounces of gold. The IMF holds 100 million ounces of gold, provided by its founders after World War II. The IMF continues to value this gold at 1950's prices – roughly $45/ounce. For the current HIPC program, the IMF revalued a small portion (around 13%) of its gold holdings at current rates, then invested the proceeds and used the interest income to pay down its HIPC loans. At a time when the international donor community is seeking financing for the current HIPC program, changes to it, as well as development financing for the Millennium Development Goals, such a mechanism could again generate large additional resources.

Debt Relief as Development Financing

As stated earlier, DATA believes debt relief needs to be part of a package of assistance, including direct assistance and trade, to help poor countries reach poverty reduction and growth goals. It makes little sense to cancel debt while cutting aid or depressing trade. Similarly, it makes little sense to give large sums of development assistance while recipient countries recycle this money into debt service payments to creditors.

Converting a portion of the World Bank's IDA lending to grants is a good strategy to avoid HIPCs from falling steadily back into unsustainable debt. The Administration's efforts in this regard should be applauded – so long as there are ongoing increases in development financing overall. Deeper cancellation of old stock piles of debt, together with converting future loans to grants, are complementary efforts to remove and prevent poor countries from staggering debt burdens.

While it is difficult to assess the relative merits of debt relief compared to aid, trade, or other forms of development finance, debt relief under the HIPC program has several features that make it an effective form of assistance:

1. *Donor Coordination* – HIPC debt relief, like any bankruptcy proceeding, requires all the creditors to act together in a coordinated fashion. Donor coordination brings efficiency for the recipient country (limiting the transaction costs of dealing with dozens of different donors with different rules and paperwork) as well as clearer goals and accountability.

2. *Country ownership* – Country ownership of development initiatives, where funding supports country priorities rather than donor priorities, is critical to program success. Through the PRSP process, the recipient government engages in a participatory process with civil society to design a country-owned poverty reduction plan, increasing the ownership over that plan.

3. *Untied aid* – Because debt relief through the HIPC program provides support directly to recipient government budgets, the countries themselves make spending decisions, using local contractors or NGOs, which are often less expensive and more attune to country priorities than donor-required contractors.

4. *Leveraging more assistance* – In the HIPC program, every dollar of U.S. taxpayer money was multiplied 30 times by contributions from other donors. When donors agree to act together in this way, with each contribution dependent on others, contributions are multiplied. A similar (although less dramatic) example of this is the leveraging impact of the Global Fund for HIV/AIDS, TB and Malaria. Every dollar from the United States to the Fund has been matched by $2 from other donors.

Reaction to the General Account Office April 2004 report

GAO provided an assessment of the costs of the existing HIPC framework, additional relief proposals, and of reaching economic growth targets.

The presentation of its findings leaves the reader with sticker shock – $375+ billion in total assistance to reach economic growth and debt relief goals. Intentional or not, this presentation gives the impression that poor countries are hopelessly far away from their goals and need an unrealistic amount of assistance.

However, a closer look paints a different picture.

1. The estimate covers 18 years.
2. The estimate is global – the U.S. would cover only a share of that (12% according to the GAO).
3. The estimate includes existing development assistance – traditional aid – and support for export earnings, in addition to costs for debt relief. While I agree poor countries need these and other components of development, this report and hearing are meant to focus on debt relief. A comprehensive look at what these countries need to achieve poverty reduction goals (like the Millennium Goals referenced in the report) is worthwhile, but needs to be put in that context.

Interestingly, using GAO's assumption that the U.S. would cover 12% of this total, the U.S. would cover $52 billion over 18 years. That is roughly $3 billion per year for the 27 HIPCs. While I do not have total U.S. aid expenditures for these 27 countries, combined U.S. spending on debt relief, the new HIV/AIDS initiative, Millennium Challenge Account, export financing and traditional aid may be close to that level already.

GAO's analysis of deepening debt relief to 5% of revenues also overstates the reality. While its analysis seems accurate, it is not analyzing the legislation Congress passed. First, GAO assumes all 27 countries would be lowered to 5%, rather than just those that suffer a public health crisis. Treasury's report indicates that 9 of the 27 would be at 10%, thus lowering the cost.

Second, GAO assumes the 5% level would be held for 18 years, rather than the 3 years in the law.

Third, GAO states the approach "could provide an incentive for countries to pursue irresponsible borrowing policies" by guaranteeing countries would not have to pay more than 5% of its revenue on debt service. The legislation, however, only applies to debt incurred in the past, in order to avoid the incentive GAO critiques.

Conclusion

The Enhanced HIPC Initiative has been a significant stride forward, and a good investment by Congress and the Administration. The United States' contribution has been multiplied 30 times by other donors, and written off 50 times its worth in debt stock. Poor countries have not only escaped from under decades of old debts, they are saving more than $1 billion in annual debt service, now putting that money to work in their countries fighting poverty. A new system of civil society participation and transparency exists, so people have a greater voice in where funding goes.

Congress has asked the Administration to go a step further, deepening debt relief for qualified countries. Again, this would be a worthwhile investment. Consider: the total cost of the current program has been $30 billion, providing roughly $1 billion in annual debt service relief. Treasury estimates going to a 5 and 10 percent formula would cost an additional $1.3 billion, which would provide another $430 million in annual debt service relief. In other words, for a small 4% increase in cost to the program, the 27 HIPCs could achieve a 50% increase in benefit – a good return for the additional investment.

I hope the Subcommittee will consider this and other mechanisms for deeper debt relief, as part of a comprehensive strategy to help the poorest countries reach their growth and poverty reduction goals.

Thank you.

HIPC Initiative: Status of Country Cases Considered Under the Initiative, September 2003

Country	Decision Point	Completion Point	Target NPV of Debt-to- Export (in percent)	Target NPV of Debt-to- Gov. revenue (in percent)	Assistance Levels 1/ (In millions of U.S. dollars, present value) Total	Bilateral	Multilateral	IMF	World Bank	Percentage Reduction in NPV of Debt 2/	Estimated Total Nominal Debt Service Relief (In millions of U.S. dollars)
Completion point reached under enhanced framework											
Benin	Jul. 00	Apr. 03	150		265	77	189	24	84	31	460
Bolivia					1,302	425	876	84	194		2,060
original framework	*Sep. 97*	*Sep. 98*	*225*		*448*	*157*	*291*	*29*	*54*	*14*	*760*
enhanced framework	*Feb. 00*	*Jun. 01*	*150*		*854*	*268*	*585*	*55*	*140*	*30*	*1,300*
Burkina Faso					553	83	469	58	231		930
original framework	*Sep. 97*	*Jul. 00*	*205*		*229*	*32*	*196*	*22*	*91*	*27*	*400*
enhanced framework	*Jul. 00*	*Apr. 02*	*150*		*195*	*35*	*161*	*22*	*79*	*30*	*300*
topping up		*Apr. 02*	*150*		*129*	*16*	*112*	*14*	*61*		*230*
Mali					538	169	369	59	187		895
original framework	*Sep. 98*	*Sep. 00*	*200*		*121*	*37*	*84*	*14*	*44*	*9*	*220*
enhanced framework	*Sep. 00*	*Feb. 03*	*150*		*417*	*132*	*285*	*45*	*143*	*29*	*675*
Mauritania	Feb. 00	Jun. 02	137	250	622	261	361	47	100	50	1,100
Mozambique					2,023	1,270	753	143	443		4,300
original framework	*Apr. 98*	*Jun. 99*	*200*		*1,717*	*1,076*	*641*	*125*	*381*	*63*	*3,700*
enhanced framework	*Apr. 00*	*Sep. 01*	*150*		*306*	*194*	*112*	*18*	*62*	*27*	*600*
Tanzania	Apr. 00	Nov. 01	150		2,026	1,006	1,020	120	695	54	3,000
Uganda					1,003	183	820	160	517		1,950
original framework	*Apr. 97*	*Apr. 98*	*202*		*347*	*73*	*274*	*69*	*160*	*20*	*650*
enhanced framework	*Feb. 00*	*May 00*	*150*		*656*	*110*	*546*	*91*	*357*	*37*	*1,300*
Decision point reached under enhanced framework											
Cameroon	Oct. 00	Floating	150		1,260	874	324	37	179	27	2,000
Chad	May. 01	Floating	150		170	35	134	18	68	30	260
Congo, Dem. Rep. of	Jul. 03	Floating	150		6,311	3,837	2,474	472	831	80	10,389
Ethiopia	Nov. 01	Floating	150		1,275	482	763	34	463	47	1,930
Gambia, The	Dec. 00	Floating	150		67	17	49	2	22	27	90
Ghana	Feb. 02	Floating	69	250	2,186	1,084	1,102	112	781	56	3,700
Guinea	Dec. 00	Floating	150		545	215	328	31	152	32	800
Guinea-Bissau	Dec. 00	Floating	150		416	212	204	12	93	85	790
Guyana					585	220	365	74	68		1,030
original framework	*Dec. 97*	*May 99*	*107*	*280*	*256*	*91*	*165*	*35*	*27*	*24*	*440*
enhanced framework	*Nov. 00*	*Floating*	*150*	*250*	*329*	*129*	*200*	*40*	*41*	*40*	*590*
Honduras	Jul. 00	Floating	110	250	556	215	340	30	98	18	900
Madagascar	Dec. 00	Floating	150		814	457	357	22	252	40	1,500
Malawi	Dec. 00	Floating	150		643	163	480	30	331	44	1,000
Nicaragua	Dec. 00	Floating	150		3,267	2,145	1,123	82	189	72	4,500
Niger	Dec. 00	Floating	150		521	211	309	28	170	54	900
Rwanda	Dec. 00	Floating	150		452	56	397	44	228	71	800
São Tomé and Príncipe	Dec. 00	Floating	150		97	29	68	-	24	83	200
Senegal	Jun. 00	Floating	133	250	488	193	259	45	124	19	850
Sierra Leone	Mar. 02	Floating	150		600	268	332	123	122	80	950
Zambia	Dec. 00	Floating	150		2,499	1,168	1,331	602	493	63	3,850
Decision point reached under original framework											
Côte d'Ivoire	Mar. 98	...	141	280	345	163	182	23	91	6 3/	800
Total assistance provided/committed					**31,428**	**15,519**	**15,778**	**2,517** 4/	**7,230**		**51,934**

Sources: IMF and World Bank Board decisions, completion point documents, decision point documents, preliminary HIPC documents, and staff calculations.

1/ Assistance levels are at countries' respective decision or completion points, as applicable.
2/ In percent of the net present value of debt at the decision or completion point (as applicable), after the full use of traditional debt-relief mechanisms.
3/ Nonreschedulable debt to non-Paris Club official bilateral creditors and the London Club, which was already subject to a highly concessional restructuring, is excluded from the NPVof debt at the completion point in the calculation of this ratio.
4/ Equivalent to SDR 2,023 million at an SDR/USD exchange rate of 0.8039.

Jubilee USA NETWORK

Debt Relief Works

The HIPC initiative has offered life-saving debt-relief that has allowed revenues to be put to good use by increasing health and education spending. Debt relief is one of the biggest success stories of recent years, and has benefited the lives of millions of people. This is money that would have been used to repay debts but has instead stayed in these countries and has been used for social services and poverty-reduction initiatives.

Here are just a few examples of the impact debt relief can have:

Tanzania- Back to School Days

Tanzania is one of 11 countries to complete the current debt relief program. According to the World Bank, Tanzania received $3 billion in debt relief. Tanzania has increased funding for poverty reduction by 130% over the last six years. Tanzania has focused the savings to increase education spending and eliminate school fees for elementary school education. ***Almost overnight, an estimated 1.6 million kids returned to school. By 2003 3.1 million children were back in school.*** The net enrollment ratio has risen from 58.8% in 2000 to 88.5% in 2003. Tanzania expects to attain universal basic education by 2006.

With debt relief savings in 2002 and 2003, Tanzania built 31,825 classrooms and the number of primary schools increased from 11,608 in 2000 to 12, 689 in 2003, a net increase of 1,081 schools. Also in these two years, 17,851 new Grade A teachers were recruited and 9,100 science-teaching kits were supplied. The pass rate in primary school exams have risen from 19.3% in 1999 to 40.1% in 2003. This rate would have been higher if the pass rate had not been raised.

(Source: President's Office, The United Republic of Tanzania, in letter dated Feb. 17, 2004)

Burkina Faso: Meeting Basic Needs with Services

Burkina Faso has focused debt relief savings on fighting AIDS, education and access to safe water. In 2002, money freed up from debt service payments were targeted to joint government and civil society initiatives to fight AIDS, which have been successful in controlling the spread of the virus and stabilizing the HIV+ share of the population which at 6.5% is significant for West African standards. Two clinics were built and the cost of drugs decreased by between 38% and 96%.

Debt relief savings have been put to use to build 746 schools, 20,251 classrooms and put over 110,000 children back in school over the last three years. Access to clean water, an essential ingredient in good health – especially for children – has increased by 26% for private families resulting in over one million people having access to safe drinking water.

(Source: IMF Country Report No. 04/79 and 04/78 of March 2004)

Mozambique: Combating HIV/AIDS

Debt relief has enabled Mozambique to make strides in combating HIV/AIDS. In 2001 a National plan to fight HIV/AIDS was launched. The programs will slow infection rates and mitigate effects through prevention, support and care. Educational programs are being carried out. 24 testing and counseling offices opened in 2001 and early 2002 and 50 offices will be up and running by 2007. More than 24,000 people were tested in 2002 alone.

(Source: IMF Country Report No. 03/201, July 2003)

Uganda- Doubled School Enrollment

Debt service payments in Uganda have dropped from $151 million a year to $88 million. The extra resources are channeled through the Poverty Action Fund, which is overseen by representatives from government, national NGOs, churches, unions and international organizations. The bulk of debt relief in Uganda has helped fund universal primary education - the number of young children attending school has increased from 2.3 million at the start of 1997 to 6.5 million by March 1999, more than doubling the enrolment rate to 94%.

(Source: Reality Check Report, Drop the Debt, April 2001)

Overall Health and Education Spending Increases

Life-saving debt relief is allowing for increases in spending on health and education in the countries that have started to receive relief. In 10 African countries studied by Jubilee Research (UK), all of which had started to receive some debt service relief by the end of 2000, the following has been documented:

- Education spending had risen from only $929 million in 1998, or less than the amount spent on debt service, to $1.3 billion in 2002, more than twice the amount spent on debt service
- Health spending had risen from $466 million, or 50% of debt service spending, to $796 million, or one third more than spending on debt service
- Over the same period there had been no increase in spending on the military.

(Source: Relief Works, A report from Jubilee Research, August 2002)

Deeper Debt Relief Would Do Even More

The American Friends Service Committee in their Life over Debt Report of 2004 estimates that if developing country governments invested in human development rather than debt payments an estimated:

- **Three million children would live beyond their fifth birthday.**
- **One million cases of malnutrition would be avoided.**

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COMMENTS ON PROPOSED MODIFICATIONS TO THE ENHANCED HEAVILY INDEBTED POOR COUNTRIES (HIPC) INITIATIVE
H.R. 1298

Report to Congress
October 2003

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COMMENTS ON PROPOSED MODIFICATIONS TO THE ENHANCED HIPC INITIATIVE (H.R. 1298)

Executive Summary

On May 27, 2003, the President signed H.R. 1298, a bill strengthening United States commitment and leadership in fighting HIV/AIDS in developing countries. Title V of the legislation advises the Treasury to commence efforts in working with international creditors and financial institutions to modify the existing enhanced Heavily Indebted Poor Country (HIPC) initiative and examine options for extending debt relief to non-HIPC countries. In accordance with H.R. 1298, the Treasury has undertaken this report to analyze the costs and economic merits of the legislation.

Key conclusions of this report are that:

- From a financial perspective, the proposed modifications are very expensive, at a time when the international community as a whole, including the United States, faces substantial challenges in completing the financing of the current HIPC initiative.

- From a broader economic development perspective, the proposed modifications are not the best means to achieve desired health sector outcomes and promote debt sustainability.

- In order to maintain long-term debt sustainability in the poorest countries, particular emphasis needs to be placed on grant assistance and limiting the accumulation of new debt.

Overview of HIPC

Launched in 1996, the Heavily Indebted Poor Country initiative is a joint effort by international creditors to reduce the external debt of poor, heavily-indebted countries. The HIPC framework was enhanced in 1999, with strong U.S. leadership, to provide deeper, broader, and faster debt relief for the poor heavily indebted countries committed to economic reform and poverty reduction. The World Bank and IMF have classified 42 countries as heavily indebted and poor; more than three-quarters of these countries are located in sub-Saharan Africa. A key feature of the enhanced HIPC initiative is the Poverty Reduction Strategy Paper (PRSP), developed by the HIPC country itself, through a participatory process involving civil society and with the support of the International Financial Institutions and donors. The PRSP is designed so that debt relief savings and new assistance are directed towards economic growth and poverty reduction.

Countries seeking debt reduction must first demonstrate commitment and performance on economic and social reforms in order to reach their HIPC "decision point." At this point, the World Bank and IMF determine what level of debt reduction is required to reach a target HIPC threshold

(generally a net present value (NPV) of debt to exports ratio of 150%). Creditors start to provide interim debt reduction (i.e., substantial cash flow relief) following the decision point. Once the country demonstrates satisfactory macroeconomic performance and achieves key objectives identified at the decision point, it can reach its HIPC "completion point," when the remainder of the debt reduction is delivered.

To date, the member governments of the IMF and World Bank have approved debt-reduction for 27 countries, 23 of them in Africa. These packages will provide nominal debt service reduction of about $51 billion ($31 billion in net present value terms).

Existing Financial Challenges

Even before considering possible changes to the enhanced HIPC initiative, there are numerous implementation challenges to complete the current program, including the mobilization of substantial additional financing. For 33 HIPC countries[1] that have been included in the HIPC financing framework from the beginning of the initiative, the following potential costs still exist:

- The World Bank and IMF have estimated that there is a shortfall of about $650 million in the HIPC Trust Fund to cover the expected HIPC costs of completing the program for the 33 countries. The HIPC Trust Fund is a multilateral trust fund financed by bilateral donors that helps to cover the HIPC costs of regional and sub-regional multilateral development banks, such as the African Development Bank. From the HIPC Trust Fund's inception through September 2002, contributions from 23 bilateral donors totaled about $2.5 billion, of which the United States contributed $600 million.

  - The U.S. has pledged $150 million to help meet this $650 million need. The Administration has requested an initial $75 million in appropriations from the Congress in FY 2004 to fund a portion of the U.S. pledge.

- The World Bank's concessional window, the International Development Association (IDA), faces additional HIPC debt relief costs estimated to exceed $500 million per year for a decade or more beyond the current IDA-13 replenishment period. These costs will need to be addressed in the context of future IDA replenishments.

- The U.S. also needs appropriations from Congress for $300 million to cover the costs of U.S. bilateral debt reduction for the Democratic Republic of the Congo, which has recently reached its HIPC decision point. This was also part of the Administration's FY 2004 budget request. Without this support, the DRC may not receive the close to $10 billion in debt reduction from all creditors that it is expected to receive under HIPC.

[1] The 42 HIPCs minus the 4 countries (Angola, Kenya, Viet Nam, and Yemen) that do not require HIPC debt reduction to meet HIPC target debt ratios, minus the 4 countries which have been in conflict and/or did not have reliable debt data (Burma, Liberia, Somalia, and Sudan), and minus Laos which has not yet decided whether to participate in HIPC.

- There are also potential "topping up" costs for some countries in this group. Topping up is a term of art applied to possible additional debt relief at the completion point if there have been exceptional exogenous shocks that cause a fundamental change in a HIPC country's economic circumstances. The most recent World Bank/IMF estimates of possible topping up costs for the HIPCs which have already reached decision point range from $700 million to $1.3 billion. This could add as much as $150 million to $300 million in costs to the HIPC Trust Fund. In addition, there might be topping up costs associated with the other HIPCs which have not yet reached their decision points.

- In addition to the above costs for 33 HIPCs, costs to implement the current HIPC initiative for Liberia, Somalia, and Sudan, assuming that they will qualify for debt reduction, would be very high. The World Bank/IMF have estimated that overall costs in terms of NPV of debt reduction would be in the range of $10 billion for the three countries, with the bulk of these costs related to Sudan. This would include substantial costs for the United States, since under the current framework 100 percent U.S. bilateral debt reduction would be provided, in addition to a U.S. share of the burden on bilateral donors to cover much of the multilateral institution costs.

In conclusion, total additional costs for the financing of the current enhanced HIPC are substantial, and could reach as much as $12 billion, excluding the costs to IDA. This would place a major burden on bilateral donors at a time when donors are trying to identify resources to provide new assistance.

Proposed Modifications and Additional Costs

H.R. 1298 proposes modifications to the enhanced HIPC initiative. It also contemplates extending debt reduction to non-HIPC countries. This section assesses the costs of implementing such actions.

Proposed Modifications to the Enhanced HIPC Initiative

The legislation proposes modifying the enhanced HIPC program by linking the amount of debt relief to debt service indicators in addition to a debt stock threshold. The Act proposes a ceiling of 10% for the debt service-to-fiscal revenues ratio for all HIPC countries for a period of 3 years. For HIPC countries suffering a public health crisis, the ceiling is reduced to 5%. A country is defined as suffering a public health crisis if HIV/AIDS incidence exceeds certain thresholds for pregnant women or certain high-risk groups (see *Appendix A* for more information).

The Treasury has undertaken an analysis of the possible cost of this proposed modification. *Table 1* shows the level of projected debt service payments for the 26 HIPC countries that had reached their decision point by mid-2003, and the amount by which the payments would have to be reduced to achieve the relevant 5% or 10% benchmark for the years 2003 through 2005. Columns (b) through (d)

show the ratio of debt service to fiscal revenues from 2003 through 2005. Columns (f) through (h) calculate the amount of debt relief required to bring that ratio to the targeted level.

Table 1
Cost of Reducing Debt Service Levels

(a)	*(b)* 2003 DS/Rev (%)[1]	*(c)* 2004 DS/Rev (%)	*(d)* 2005 DS/Rev (%)	*(e)* Debt/Rev Target (%)	*(f)* Additional debt relief 2003 ($MM)	*(g)* Additional debt relief 2004 ($MM)	*(h)* Additional debt relief 2005 ($MM)	*(i)* Total Relief ($MM)
Countries Suffering a Public Health Crisis								
Benin	8%	6%	5%	5%	$12	$7	$1	$21
Burkina Faso	4%	4%	4%	5%	$0	$0	$0	$0
Mali	11%	10%	8%	5%	$33	$29	$22	$84
Mozambique	9%	8%	7%	5%	$24	$18	$18	$61
Tanzania	7%	7%	8%	5%	$18	$25	$40	$83
Uganda	6%	7%	5%	5%	$6	$19	$0	$25
Cameroon	10%	10%	10%	5%	$85	$97	$101	$282
Chad	10%	7%	8%	5%	$10	$7	$10	$27
Ethiopia	4%	4%	4%	5%	$0	$0	$0	$0
Ghana	6%	4%	4%	5%	$0	$0	$0	$0
Guinea	19%	16%	13%	5%	$60	$51	$43	$155
Guyana	12%	10%	9%	5%	$16	$14	$11	$41
Malawi	8%	8%	7%	5%	$14	$12	$11	$36
Niger	9%	9%	8%	5%	$10	$11	$10	$32
Rwanda	3%	3%	3%	5%	$0	$0	$0	$0
Sierra Leone	23%	23%	4%	5%	$24	$26	$0	$50
Zambia	10%	13%	11%	5%	$38	$67	$55	$159
Countries Not Suffering a Public Health Crisis								
Bolivia	9%	8%	6%	10%	$0	$0	$0	$0
Mauritania	11%	11%	11%	10%	$4	$2	$2	$8
São Tomé and Príncipe	8%	4%	4%	10%	$0	$0	$0	$0
Senegal	12%	18%	10%	10%	$24	$90	$1	$115
Nicaragua	15%	10%	9%	10%	$31	$0	$0	$31
Honduras	15%	11%	9%	10%	$61	$11	$0	$73
Madagascar	5%	5%	5%	10%	$0	$0	$0	$0
Guinea-Bissau	13%	6%	4%	10%	$2	$0	$0	$2
The Gambia	9%	9%	10%	10%	$0	$0	$0	$0
							TOTAL ($MM)	**$1,284**

Notes:
(1) DS/Rev = ratio of Debt Service/Fiscal Revenues after HIPC and additional bilateral relief
Note: ratio excludes debt service on new borrowing since decision point
Note: debt service includes only obligations on outstanding long-term debt on public and publicly-guaranteed debt
Sources: HIPC Decision & Completion Point documents; IMF & IDA estimates; The Enhanced HIPC Initiative and the Achievement of Long-term External Debt Sustainability, IDA/SecM2002-0162.

As can be seen, the modification could require on the order of an additional $1.3 billion in debt reduction from international creditors for 26 HIPC countries. Much of these costs would fall on the United States and other bilateral donors. Seventeen of the countries would qualify as having public health crises, and 19 of the 26 countries would receive additional debt relief, with 4 countries – Guinea, Cameroon, Zambia and Senegal – constituting over half of the total amount due to their higher debt service burdens.

It should be noted that only 26 decision point countries – for which there was readily available data – were included in the analysis. There remain 11 other HIPC countries that could be expected to reach a decision point, and their inclusion in the analysis would increase costs to international creditors.

Treasury's cost estimates are in line with other studies. The General Accounting Office conducted a brief study in October 2002 and placed the overall cost of the proposed modification at \$2.7 billion. The GAO estimated that approximately 20% of the \$1.8 billion multilateral portion of the total cost, or \$360 million, could be the USG share. The World Bank/IMF also estimated the cost of similar proposals in a September 2002 HIPC Progress Report and came up with a range, depending on the debt service-to-revenue threshold. If all decision point HIPCs were brought to the 10% threshold for a three-year period, the cost would be \$1.2 billion. For a ceiling of 5%, that figure would increase to \$3.8 billion. The cost estimates are summarized in *Table 2.*

Table 2
Cost Estimates of Debt Service Relief Proposal for 26 HIPCs

Source	*Cost to Creditors*
U.S. Treasury	\$1.3 billion
IMF	\$1.2 billion if all countries brought to 10% level. \$3.8 billion if all countries brought to 5% level.
GAO	\$2.7 billion

The Treasury, GAO and IMF estimates are all based on World Bank and IMF data; Treasury used data compiled in 2002, which was the most recent readily available data in aggregate form. The Treasury estimates are on the lower end, reflecting the fact that H.R. 1298 specifies that debt service on new borrowing since the decision point is excluded from the calculations. Also, there may be slight differences between GAO and Treasury estimates due to differing classification of countries as suffering a public health crisis.

In addition to debt service relief, the legislation calls for limiting the ratio of the present value of debt to exports to 150% at the country's decision point[2] and possibly for the three years following the date of enactment of the legislation. It is not clear how such debt relief should be calculated for the three years, since the legislation provides instructions on debt reduction only at the country's decision

[2] For countries that have yet to reach their decision point, the ratio would be limited as of the date of the enactment of the legislation.

point. Moreover, it is not clear what debt relief might be required beyond enhanced HIPC requirements. For the 26 countries that have reached a decision point, the legislation ostensibly proposes very little that is different from what is already codified in the enhanced HIPC plan, i.e. bringing debt-to-export levels down to 150%. The only discernible difference is that the enhanced HIPC framework uses a three-year rolling average for the level of exports when calculating the ratio. The legislation stipulates using exports from the 12 months preceding the decision point.

Cost of Extending Relief to Non-HIPC Countries

The Act also advises the Treasury to determine the cost of extending debt relief to countries not included in the HIPC initiative. The Treasury conducted such an analysis, using specifically – as directed in the Act – the debt service-to-revenue metric explained above as well as the enhanced HIPC initiative's 150% debt-to-export benchmark. The analysis includes countries classified as low-income economies by the World Bank.[3]

The results of the analysis are shown in *Table 3*.

Table 3
Cost of Extending Debt Relief to Non-HIPC Countries

	10% Debt Service/Revenue Provision							**150% Debt/Exp Provision**			**Total**
	Debt Service/Revenue (%)[1]			*Additional Debt Relief ($MM)*				*Additional Debt Relief ($MM)*			*Maximum*
	(a)	*(b)*	*(c)*	*(d)*	*(e)*	*(f)*	*(g)*	*(h)* PV Debt/ Exports (%) 2001	*(i)* PV Debt ($MM)	*(j)* Additional Debt Relief ($MM)	Maximum (g) or (i)
	2003	2004	2005	2003	2004	2005	Total				
Armenia	na	na	na	na	na	na	...	115	654	0	0
Azerbaijan	na	na	na	na	na	na	...	49	994	0	0
Bangladesh	na	na	na	na	na	na	...	113	9,712	0	0
Bhutan	19	18	17	9	9	9	27	151	245	2	27
Cambodia	13	13	13	16	16	17	48	159	2,301	129	129
Equatorial Guinea	na	na	na	na	na	na	...	8	193	0	0
Eritrea	na	na	na	na	na	na	...	82	235	0	0
Georgia	17	17	17	38	36	38	112	118	1,066	0	112
Haiti	14	13	14	11	10	11	32	154	817	20	32
India	6	5	5	0	0	0	...	91	67,760	0	0
Indonesia	20	18	17	3,430	2,800	2,664	8,894	198	131,357	31,847	31,847
Kyrgyz Republic	na	na	na	na	na	na	..	225	1,326	443	443
Lesotho	10	9	9	0	0	0	..	74	406	0	0
Moldova	na	na	na	na	na	na	...	134	1,126	0	0
Mongolia	8	8	9	0	0	0	...	103	606	0	0
Nepal	15	14	15	30	30	32	92	92	1,567	0	92
Nigeria	13	13	13	590	519	521	1,629	154	30,882	841	1,629
Pakistan	13	13	14	360	361	442	1,163	238	25,457	9,380	9,380
Papua New Guinea	17	16	15	58	52	44	153	98	2,188	0	153
Solomon Islands	7	9	10	0	0	0	0	68	112	0	0
Sri Lanka	14	14	14	106	110	111	327	95	6,909	0	327
Tajikistan	51	47	44	55	53	51	158	109	853	0	158
Ukraine	na	na	na	na	na	na	...	59	11,483	0	0
Uzbekistan	na	na	na	na	na	na	...	136	4,444	0	0
Zimbabwe	na	na	na	na	na	na	...	161	3,493	242	242
Total											**44,571**

Source: Global Development Finance (PV debt, debt service and export figures) and International Financial Statistics (revenue)
(1) Revenues are latest available between 1998 and 2002 and then escalated by 5% through 2005
Debt Service includes contractual obligations on outstanding external long-term public and publicly-guaranteed debt

[3] The 2002 per capita Gross National Income threshold for low-income economies is $735.

As can be seen, the total amount of debt forgiveness to achieve the standards proposed in the Act for this group of countries is estimated at $45 billion. There are a few comments worth noting on the methodology and results:

- *Indonesia, Pakistan and Nigeria*: The high costs are driven mainly by the inclusion of three poor and highly indebted countries. They account for roughly 95% of the overall costs.

- *10% Debt Service/Revenue Benchmark*: A 10% benchmark was applied to all countries in order to arrive at a conservative cost estimate. The cost when applying the reduced 5% ratio to all countries increases to $49 billion.

- *Need for Revenue Figures*: For a number of countries, revenue levels were unavailable. Inclusion of such revenue figures would likely increase the overall cost of debt relief.

- *Debt Service or Debt Stock Reduction*: Given the difficulty of trying simultaneously to assess and combine levels of debt service and debt stock reduction needed to achieve the targets proposed in H.R. 1298, this table simply takes the maximum of the two to provide a cost estimate.

In sum, the cost of implementing proposals raised in H.R. 1298 – reducing debt service and including non-HIPC countries – could cost international creditors $46 billion, with substantial costs for bilateral donors. As noted above, this may be an underestimate, since only the first 26 HIPCs are counted, and data is lacking on a number of other low-income countries. These substantial costs would be <u>in addition to</u> as much as $12 billion or more for the international community to complete the current HIPC program, as well as the costs in future IDA replenishments.

<u>Other Concerns with the Proposed Modifications to HIPC</u>

Apart from cost concerns, there are significant policy concerns with amending the HIPC framework as proposed in the legislation. The Administration has made a concerted effort to implement the HIPC debt reduction program in an effective manner, and move the focus beyond debt reduction to a broader focus on the challenges of economic growth and development.

As highlighted in the World Bank's Operation Evaluation Department (OED) evaluation[4] of the HIPC program, continued focus on HIPC and debt relief has been a distraction in terms of the greater emphasis needed on well-defined economic growth strategies in these countries. The OED report stressed that HIPC debt relief is not a panacea, and that given institutional capacity constraints in the HIPCs, debt relief is not an efficient way of achieving desired social sector outcomes.

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[4] "The Heavily Indebted Poor Countries (HIPC) Debt Initiative: An OED Review." February, 2003.

Moreover, debt relief may be an ineffective means of targeting countries suffering a public health crisis. For instance, according to Treasury's analysis, Burkina Faso suffers high HIV/AIDS incidence but would receive no assistance. On the other hand, Guinea would receive $155 million in assistance even though their HIV/AIDS incidence is lower than Burkina Faso's. Such disparate treatment is unfair to those countries that are suffering a public health crisis but have managed to keep their debt service-to-revenue ratio low.

The Administration believes that direct assistance for HIV/AIDS objectives is a more effective way to achieve desired results. The Administration has aggressively sought funding in the fight against HIV/AIDS, tuberculosis and malaria. For FY 2004, the Administration has requested $2 billion to fund multilateral and bilateral efforts. In addition, President Bush announced his Emergency Plan for AIDS Relief, which provides $15 billion, including nearly $10 billion in new funding, to fight the HIV/AIDS pandemic over the next 5 years.

Another key problem with the proposal is that incorporating a debt service-to-revenue benchmark would introduce a moral hazard problem for foreign governments. This is in addition to the existing moral hazard problem associated with the 150% debt-to-export benchmark. As the IMF/World Bank state:

> "Additional debt reduction to further limit debt-service payments raises the issue of moral hazard and could provide the wrong incentives to HIPCs: to the extent that losses in export earnings or reductions in revenue would be compensated by increased debt relief, countries will have little or no incentive to increase and/or diversify their exports, improve revenue collection, and to pursue policies consistent with these goals."[5]

In addition to the moral hazard problem, there is the serious concern that the proposed modifications would do nothing to assist countries achieve long-term debt sustainability. In its October 2002 report to Congress, the GAO analyzed the proposal to link debt relief to debt service-to-revenue ratios for the HIPCs and came to the following conclusions:

> "[The proposal] would cost about $2.7 billion (present value) for 26 countries over the next 3 years and have no effect on long-term sustainability."

The report went on to state that extending such debt relief would facilitate debt sustainability if implemented for a 20-year period, but the costs would increase to $7-12 billion for the 26 countries.

<u>Debt Sustainability</u>

As mentioned above, providing additional debt relief linked to debt service targets for a few years does virtually nothing in terms of long-term debt sustainability. Most important for debt sustainability going forward are sound economic policies and prudent debt management. Both

[5] IMF/World Bank joint report. Heavily Indebted Poor Countries (HIPC) Initiative: Status of Implementation. September 23, 2002

borrowers and lenders must work to avoid accumulation of too much new debt that might result in new debt problems.[6] Concerns about the vulnerability of some poor countries to future debt problems was a key factor in President Bush's proposal for a major increase in grant assistance from the multilateral development banks.

Following up on strong concerns about long-term debt sustainability expressed by the United States and other member countries, the IMF and World Bank have held a series of workshops on debt sustainability in low-income countries, and the Executive Boards will be considering policy recommendations in the coming months. The United States and other members of the two institutions will also be examining possible options to address the impact of external shocks, given that external shocks can have a major impact on debt sustainability for this group of countries.

Conclusions

The Treasury has carefully examined the proposed modifications to the HIPC initiative contained in H.R. 1298. On both cost and policy grounds, it would not be advisable to modify the HIPC target debt thresholds to incorporate debt service indicators, or to expand HIPC debt reduction to non-HIPC countries. With respect to debt reduction, the priority should be to implement effectively the current HIPC program, including the mobilization of the substantial additional financing that is needed.

[6] Recent work by the IMF and World Bank, in the context of updating cost projections for "topping up" of HIPC debt relief, has highlighted that the main cause of higher debt ratios for possible topping up candidates is new borrowing. The report notes that if there had been no new borrowing since HIPC decision points, there would be no need for any topping up. Source: IMF document SM/03/295, "Enhanced Initiative for Heavily Indebted Poor Countries – Considerations Regarding the Calculation of Additional Debt Relief at the Completion Point," August 2003.

Appendix A

A country is defined as suffering a health crisis if the country's infection rate is greater than 5% among women attending prenatal clinic or greater than 20% in groups with high-risk behavior.

HIV/AIDS Infection Rates in the HIPCs

	HIV/AIDS Infection Rate (%)						
					High Risk Groups		
	Adult Population (end-2001)	Year	Pregnant Women 1 2	Year	STI Patients 1 2 3	Year	Sex Workers 1 2
Countries that have reached their Completion Points							
Bolivia	0.1	2000	0.0	1997	2.0	1997	0.0
Burkina Faso	6.5	2000	6.3	1992	41.8	1994	58.2
Mali	1.7	1999	3.0	…	…	1995	42.1
Mauritania	0.0	1994	0.5	1996	1.7	..	0.0
Mozambique	13.0	2000	14.4	1999	15.1	…	0.0
Tanzania	7.8	1999	16.7	1997	14.8	2000	3.5
Uganda	5.0	2000	11.3	1999	2.3	1997	65.9
Countries that have reached their Decision Points							
Benin	3.6	1999	2.3	1999	3.9	1999	40.8
Cameroon	11.8	2000	9.0	2000	22.0	1995	16.4
Chad	3.6	2001	5.9	2000	12.7	1995	13.4
Ethiopia	6.4	2000	14.9	1992	37.5	1998	73.7
The Gambia	1.6	1997	1.0	1991	4.4	1993	13.6
Ghana	3.0	2000	3.8	1999	39.0	1998	50.0
Guinea	…	1996	2.1	1996	4.0	1994	36.6
Guinea-Bissau	2.8	1997	2.5	1987	6.0	…	0.0
Guyana	2.7	1997	3.8	1997	21.5	2000	45.0
Honduras	1.6	1998	2.9	1991	11.2	1999	7.7
Madagascar	0.3	1996	0.0	1995	0.3	1998	0.0
Malawi	15.0	2001	20.1	1996	54.8	1994	70.0
Nicaragua	0.2	…	0.0	…	0.0	1990	1.6
Niger	…	1993	1.3	1992	4.1	1997	23.6
Rwanda	8.9	2000	23.0	1996	41.8	…	…
São Tomé and Príncipe	…	..	0.0	…	0.0	…	0.0
Senegal	0.5	1998	0.5	1998	3.0	1998	7.0
Sierra Leone	7.0	1996	6.9	1992	3.3	1995	26.7
Zambia	21.5	2001	30.7	1992	58.0	1998	68.7
Countries still to be considered							
Côte d'Ivoire	9.7	2000	9.0	2000	25.0	1999	36.0
Burundi	8.3	1998	18.6	..	…	1993	42.2
Central African Republic	12.9	1996	11.6	1996	19.0	1989	18.9
Comoros	…	1996	0.0	1996	0.0	1994	56.8
Congo, Dem. Rep. of	4.9	1999	4.1	1997	12.2	1997	29.0
Congo, Rep. of	7.2	2000	10.0	1990	18.0	1987	49.2
Lao PDR	<0.1	1996	0.4	…	0.0	1992	1.2
Liberia	..	1993	4.0	1993	5.1	…	0.0
Myanmar	…	2001	1.3	2001	20.5	2001	33.5
Somalia	1.0	1998	0.0	1990	0.0	1990	2.4
Sudan	2.6	1998	0.5	1998	94.0	1989	16.0
Togo	6.0	1998	4.6	1992	45.2	1997	48.1
Potentially sustainable cases							
Angola	5.5	2001	3.4	1992	2.5	1999	19.4
Kenya	15	2000	15.3	1998	29.0	2000	27.0
Vietnam	0.3	1999	0.2	1999	2.0	2000	11.0
Yemen, Rep. Of	0.1		0.0	1998	2.9	1998	4.6

Source: Country Epidemiological Fact Sheets. UNAIDS website -- www.unaids.org.

1 Median prevalence rates.

2 Major urban areas.

3. STI = Sexually Transmitted Infections

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at 2:30 p.m. EDT
Tuesday, April 20, 2004

DEVELOPING COUNTRIES

Challenges in Financing Poor Countries' Economic Growth and Debt Relief Targets

Statement of Mr. Thomas Melito
Acting Director
International Affairs and Trade

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Highlights

Highlights of GAO-04-688T, a testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, House of Representatives

Why GAO Did This Study

The Heavily Indebted Poor Countries (HIPC) Initiative, established in 1996, is a bilateral and multilateral effort to provide debt relief to poor countries to help them achieve economic growth and debt sustainability. Multilateral creditors are having difficulty financing their share of the initiative, even with assistance from donors. Under the existing initiative, many countries are unlikely to achieve their debt relief targets, primarily because their export earnings are likely to be significantly less than projected by the World Bank and International Monetary Fund (IMF).

In a recently issued report, GAO assessed (1) the projected multilateral development banks' funding shortfall for the existing initiative and (2) the amount of funding, including development assistance, needed to help countries achieve economic growth and debt relief targets.

The Treasury, World Bank, and African Development Bank commented that historical export growth rates are not good predictors of the future because significant structural changes are under way in many countries that could lead to greater growth. We consider these historical rates to be a more realistic gauge of future growth because of these countries' reliance on highly volatile primary commodities and other vulnerabilities such as HIV/AIDS.

www.gao.gov/cgi-bin/getrpt?GAO-04-688T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas Melito at (202) 512-9601, or e-mail Melitot@gao.gov.

April 20, 2004

DEVELOPING COUNTRIES

Challenges in Financing Poor Countries' Economic Growth and Debt Relief Targets

What GAO Found

The three key multilateral development banks we analyzed face a funding shortfall of $7.8 billion in 2003 present value terms, or 54 percent of their total commitment, under the existing HIPC Initiative. The World Bank has the most significant shortfall—$6 billion. The African Development Bank has a gap of about $1.2 billion. Neither has determined how it would close this gap. The Inter-American Development Bank is fully funding its HIPC obligation by reducing its future lending resources to poor countries by $600 million beginning in 2009. We estimate that the cost to the United States, based on its rate of contribution to these banks, could be an additional $1.8 billion. However, the total estimated funding gap is understated because (1) the World Bank does not include costs for four countries for which data are unreliable and (2) all three banks do not include estimates for additional relief that may be required because countries' economies deteriorated after they qualified for debt relief.

Even if the $7.8 billion gap is fully financed, we estimate that the 27 countries that have qualified for debt relief may need an additional $375 billion to help them achieve their economic growth and debt relief targets by 2020. This $375 billion consists of $153 billion in expected development assistance, $215 billion to cover lower export earnings, and at least $8 billion in debt relief. Most countries are likely to experience higher debt burdens and lower export earnings than the World Bank and IMF project, leading to an estimated $215 billion shortfall over 18 years. To reach debt targets, we estimate that countries will need between $8 billion and $20 billion, depending on the strategy chosen. Under these strategies, multilateral creditors switch a portion of their loans to grants and/or donors pay countries' debt service that exceeds 5 percent of government revenue. Based on its historical share of donor assistance, the United States may be called upon to contribute about 14 percent of this $375 billion, or approximately $52 billion over 18 years.

Estimated Cost to Achieve Economic Growth and Debt Relief Targets for 27 Countries through 2020 in 2003 Present Value Terms

Source: GAO analysis of World Bank and IMF data.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the funding of the existing Heavily Indebted Poor Countries (HIPC) Initiative and the amount of further assistance needed to help countries achieve economic growth and debt targets.

The HIPC Initiative is a joint bilateral and multilateral effort to provide debt relief to up to 42 poor countries to help them achieve long-term economic growth and debt sustainability.[1] The current cost for the initiative is projected at about $41 billion in present value terms, funded almost equally between bilateral and multilateral creditors.[2] Although the initiative was launched in 1996, multilateral creditors are still having difficulty financing their share of the initiative, even with assistance from donors. GAO and others have reported that the existing initiative is unlikely to provide sufficient debt relief to achieve long-term debt sustainability, primarily because export earnings are likely to be significantly less than projected by the World Bank and the International Monetary Fund (IMF).

My remarks will focus on two key areas, as discussed in our recently released report:[3] (1) the multilateral development banks' (MDB) projected funding shortfall for the existing HIPC Initiative and (2) the amount of funding, including development assistance, needed to help countries achieve economic growth and debt relief targets. I will highlight the key financing challenges in these two areas.

[1]Under the HIPC Initiative a country is considered to be "debt sustainable" if, in most cases, the ratio of a country's debt (in present value terms) to the value of its exports is at or below the150-percent threshold, which is believed to contribute to countries' ability to make their future debt payments on time and without further debt relief.

[2]All figures in this statement are stated in 2003 present value terms, unless otherwise noted. The present value of debt is a measure that takes into account the concessional, or below market, terms that underlie most of these countries' loans. The present value is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. The nominal value of the debt is greater than the present value. The cost estimate is for 34 countries, because 4 countries are not likely to need relief under the initiative and data for 4 other countries are considered unreliable.

[3]U.S. General Accounting Office, *Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, GAO-04-405 (Washington, D.C.: Apr. 14, 2004).

Our analysis of the funding shortfall focused on the three key MDBs—the World Bank/International Development Association (IDA), the African Development Bank (AfDB)/African Development Fund (AfDF), and the Inter-American Development Bank (IaDB)/Fund for Special Operations (FSO)—because they account for about 70 percent of multilateral creditors' debt relief costs. To determine the amount and timing of funding shortfalls, we analyzed the banks' total and annual cost estimates and funding sources for 34 countries. To determine the amount of funding needed to achieve economic growth and debt relief targets, we analyzed World Bank and IMF projections through 2020 for the 27 countries that have qualified for debt relief thus far, focusing on estimates of key economic variables including debt stock, debt service, donor assistance, government revenue, and exports. In addition, we analyzed the impact of fluctuations in export growth on the likelihood of these countries achieving debt sustainability. We performed our work from June 2003 to February 2004 in accordance with generally accepted government auditing standards.

Summary

The three key MDBs we analyzed face a funding shortfall of $7.8 billion in present value terms, or 54 percent of their total commitment, under the debt relief initiative. The World Bank and the AfDB have not determined how they would close this gap. The World Bank has the most significant shortfall—$6 billion. Despite significant assistance from donor governments, the AfDB has a financing gap of about $1.2 billion. The IaDB is fully funding its HIPC obligation by reducing its future lending resources to poor countries by $600 million beginning in 2009. Based on the rates at which the United States contributes to these three multilateral development banks, we estimate that the United States could be asked to contribute an additional $1.8 billion to close the known financing shortfall for debt relief. However, the total estimated funding gap is understated because the World Bank does not include costs for four countries that are eligible for debt relief but for which data are unreliable. In addition, all three banks do not include estimates for additional relief that may be provided due to deterioration in the countries' economic circumstances since they qualified for debt relief under the existing initiative. The World Bank and the IMF project that this additional relief could cost from $877 million to $2.3 billion.

Even if donors fully fund the current initiative, we estimate that the 27 countries that have qualified for debt relief may need more than $375 billion, in present value terms, in additional assistance from donors to help them achieve their economic growth and debt relief targets by 2020. This

$375 billion consists of $153 billion in expected development assistance, $215 billion in assistance to cover lower export earnings, and at least $8 billion in relief to reach debt targets. Based on our analysis of World Bank and IMF projections, these countries will need $153 billion to help them achieve their economic growth projections and debt sustainability. However, we consider that amount to be an underestimate because it assumes that countries will achieve overly optimistic export growth rates. Under lower, more realistic historical export growth rates, 23 of the 27 countries are likely to experience higher debt burdens and lower export earnings, leading to an estimated $215 billion shortfall over 18 years. In addition, we estimate that countries will need between $8 billion and $20 billion in debt relief to achieve their debt targets, depending on the strategy chosen. Under these strategies, multilateral creditors switch a portion of their loans to grants and/or donors pay countries' debt service that exceeds 5 percent of government revenue. Based on its historical share of bilateral and multilateral assistance, the United States may be asked to contribute about 14 percent of the $375 billion in additional assistance, or approximately $52 billion over 18 years.

Background

The World Bank and IMF have classified 42 countries as heavily indebted and poor; three quarters of these are in Africa. In 1996, creditors agreed to create the HIPC Initiative to address concerns that some poor countries would have debt burdens greater than their ability to pay, despite debt relief from bilateral creditors. In 1999, in response to concerns about the continuing vulnerability of these countries, the World Bank and the IMF agreed to enhance the HIPC Initiative by more than doubling the estimated amount of debt relief and increasing the number of potentially eligible countries. A major goal of the HIPC Initiative is to provide recipient countries with a permanent exit from unsustainable debt burdens. To date, 27 poor countries have reached their decision points, and 11 of these have reached their completion points.[4] In 1996, to help multilateral creditors meet the cost of the HIPC Initiative, the World Bank established a HIPC Trust Fund with contributions from member governments and some multilateral creditors. The HIPC Trust Fund has received about $3.4 billion (nominal) in bilateral pledges and contributions, including $750 million in pledges from the U.S. government.

[4] The 11th country, Niger, reached its completion point just prior to the publication of our full report. Eligibility for the HIPC Initiative is scheduled to expire at the end of calendar year 2004. However, previous sunset dates have been extended.

Key Multilateral Development Banks Face Significant Challenges to Financing the Existing Initiative

The World Bank, AfDB, and IaDB face a combined financing shortfall of $7.8 billion in present value terms under the existing HIPC Initiative (see table 1).

Table 1: Financing Challenges Facing Key Multilateral Creditors (U.S. dollars in 2003 present value terms)

Institution	Estimated amount of debt relief (billions)	Financing identified (billions)	Estimated financing gap (billions)	Estimated U.S. share of financing gap
World Bank (34 countries)[a]	IDA 8.8 IBRD 0.7 **Total 9.5**	IDA 2.8 IBRD 0.7 **Total 3.5**	IDA 6.0	1.2 billion
African Development Bank Group (32 countries)[b]	3.5	2.3	1.2	Between 132 and 348 million
Inter-American Development Bank (4 countries)[c]	1.4	0.8	0.6[d]	300 million
Total	**14.4**	**6.6**	**7.8**	**Between 1.6 and 1.8 billion**

Source: GAO analysis of World Bank, African Development Bank Group, and Inter-American Development Bank data.

Notes:

IDA = International Development Association

IBRD = International Bank for Reconstruction and Development

[a]Of the 42 countries potentially eligible for debt relief, 4 countries are not likely to need relief under the initiative. Of the remaining 38 countries, the World Bank does not include estimates for 4 countries whose data it considers unreliable.

[b]Of the 42 countries potentially eligible for debt relief, 34 countries are members of the AfDB. Of these 34 countries, 2 countries are not likely to need relief under the initiative.

[c]Of the 42 countries potentially eligible for debt relief, only 4 countries are members of the IaDB.

[d]The IaDB's estimated financing includes a reduction in future lending resources in the Fund for Special Operations, its concessional lending arm.

The World Bank Has An Estimated Financing Gap of $6 Billion

Financing the enhanced HIPC Initiative remains a major challenge for the World Bank. The total cost of the enhanced HIPC Initiative to the World Bank for 34 countries is estimated at $9.5 billion. As of June 30, 2003, the World Bank had identified $3.5 billion in financing, resulting in a gap of about $6 billion (see table 1). Donor countries will be reviewing the financing gap during the IDA-14 replenishment discussions beginning in spring 2004.[5] If donor countries close the financing gap through future replenishments, we estimate that the U.S. government could be asked to contribute $1.2 billion,[6] which is based on its historical replenishment rate of 20 percent to IDA.[7]

Over 70 percent of the funds IDA has identified thus far come from transfers of IBRD's net income to IDA. Although IBRD has not committed any of its net income for HIPC debt relief beyond 2005, we estimate that the financing gap of $6 billion could be reduced to about $3.5 billion, or by about 42 percent, if the net income transfers from the IBRD continue.[8] Similarly, the U.S.'s potential share decreases by the same percentage, from $1.2 billion to about $700 million.[9] However, transferring more of IBRD's net income to HIPC debt relief could come at the expense of other IBRD priorities.

[5]Replenishment refers to periodic contributions by member countries that are agreed upon by the institution's board of governors to fund concessional lending operations over a specified period of time, normally every 3 years. IDA's next replenishment (the 14th) is expected to take effect in July 2005.

[6]Factors such as changes in the foreign exchange value of the U.S. dollar could substantially alter total costs.

[7]According to IDA's Articles of Agreement, the Association shall review the adequacy of its resources and authorize an increase in members' subscriptions. All decisions to increase members' subscriptions are made by a two-thirds majority of the total voting power. No member is obligated to subscribe; however, not participating in an increase may affect a country's voting power and influence in the Association.

[8]For this analysis, we assumed that IBRD's net income transfers continue until 2021 at the maximum rate of $240 million per year beginning in 2006 and decline thereafter to cover all remaining scheduled HIPC relief though 2035.

[9]While the U.S. government is not legally obligated to help close the HIPC financing shortfall of the MDBs, the United States may have an implicit fiscal exposure, which is an implied commitment embedded in the government's current policies or in the public's expectations about the role of the government. See U.S. General Accounting Office, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003) for a discussion of implicit exposures.

AfDB Has a Financing Gap of at Least $1 Billion

The total cost of the enhanced HIPC Initiative to the AfDB for its 32 member countries is estimated at about $3.5 billion (see table 1).[10] As of September 2003, the AfDB has identified financing of approximately $2.3 billion, including $2 billion from the HIPC Trust Fund and about $300 million from its own resources. Thus, AfDB is faced with a financing shortfall of about $1.2 billion in present value terms. We estimate that AfDB will need about $400 million to cover its shortfall for its 23 eligible countries, as well as about $800 million for its 9 potentially eligible countries.[11] In addition, we estimate that the U.S. share of the AfDB's financing shortfall is between $132 and $348 million, depending on the method used to close the $1.2 billion shortfall.

IaDB Expects to Finance HIPC Commitments at the Expense of Future Lending

The IaDB expects to provide about $1.4 billion for HIPC debt relief to four countries—Bolivia, Guyana, Honduras, and Nicaragua. Most of the relief is for debt owed to the Fund for Special Operations (FSO), the concessional lending arm of the IaDB that provides financing to the bank's poorer members. As of January 2004, the IaDB has identified financing for the full $1.4 billion, about $200 million from donor contributions through the HIPC Trust Fund and $1.2 billion through its own resources. Although the IaDB is able to cover its full participation in the HIPC Initiative, the institution faces about a $600 million reduction in the lending resources of its FSO lending program from 2009 through 2019 as a direct consequence of providing HIPC debt relief. According to IaDB officials, the FSO will not have enough money to lend from 2009 through 2013. To eliminate this shortfall, donor countries may be asked to provide the necessary funds through a future replenishment contribution.[12] Assuming that donor countries agree to close the financing gap, we estimate that the U.S. government could be asked to contribute about $300 million so that the FSO can continue lending to poor countries after 2008. This estimate is

[10]Most of the debt of these countries is owed to the AfDF, the concessional lending arm of the bank.

[11]According to the AfDB, the $800 million is likely to be an underestimate, given that most of the nine remaining countries are post-conflict countries that will require high levels of debt relief when the international community determines that they are ready to become eligible for HIPC debt relief.

[12]According to the IaDB's Articles of Agreement, the FSO shall be increased through additional contributions by a three-fourths majority of the total voting power of the member countries when the Board of Governors considers it advisable. No member, however, is obligated to contribute any part of such increase, although not contributing may affect a country's voting power and influence in the Bank.

based on the 50-percent rate at which the United States historically contributes to the FSO.

Financing Shortfall Is Understated

The $7.8 billion shortfall for the three MDBs is understated for two reasons. First, the estimated financing shortfall for two institutions—IDA and the AfDB—is understated because the data for four likely recipient countries—Laos, Liberia, Somalia, and Sudan—are unreliable. The World Bank considers existing estimates of the countries' total debt and outstanding arrears to be incomplete, subject to significant change, and it is uncertain when the countries will reach their decision points. Similarly, the estimated costs of debt relief for three of AfDB's countries—Liberia, Somalia, and Sudan—are likely understated due to data reliability concerns.

Second, the financing shortfall does not include any additional relief that may be provided to countries because their economies deteriorated since they originally qualified for debt relief. Under the enhanced HIPC Initiative, creditors and donors could provide countries with additional debt relief above the amounts agreed to at their decision points, referred to as "topping up." This relief could be provided when external factors, such as movements in currency exchange rates or declines in commodity prices, cause countries' economies to deteriorate, thereby affecting their ability to achieve debt sustainability. The World Bank and IMF project that seven to nine countries may be eligible for additional debt relief, and their preliminary estimates range from $877 million to about $2.3 billion, depending on whether additional bilateral relief is included or excluded from the calculation.[13] The additional cost to the U.S. government could range from $106 million to $207 million for assistance to the World Bank and AfDB, based on the U.S. historical replenishment rates to these banks.[14] Furthermore, the topping-up estimate considered only the 27

[13]Declines in discount rates and the U.S. dollar exchange rate since these preliminary cost estimates were calculated could further increase total costs. The World Bank and IMF estimate that the cost in the baseline scenario could rise to between $1.5 billion and $3.4 billion, using lower exchange and discount rates prevailing as of June 30, 2003 (end-December 2002 for those countries likely to reach completion point in 2003).

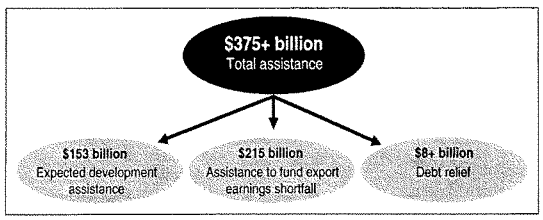
[14]Using updated exchange and discount rates, the estimated additional cost to the U.S. government could range from $179 million to $316 million for assistance to the World Bank and AfDB.

countries that have reached their decision or completion point; the estimate may rise as additional countries reach their decision points.[15]

Achieving Economic Growth and Debt Relief Targets Requires Substantial Financial Assistance

Even if the $7.8 billion shortfall is fully financed, we estimate that, if exports grow slower than the World Bank and IMF project, the 27 countries that have qualified for debt relief may need more than $375 billion in additional assistance to help them achieve their economic growth and debt relief targets through 2020. This $375 billion consists of $153 billion in expected development assistance, $215 billion in assistance to fund shortfalls from lower export earnings, and at least $8 billion for debt relief (see fig. 1). If the United States decides to help fund the $375 billion, we estimate it would cost approximately $52 billion over 18 years.

Figure 1. Estimated Cost to Achieve Economic Growth and Debt Relief Targets for 27 Countries through 2020 in 2003 Present Value Terms



Source: GAO analysis of World Bank and IMF data.

Countries Projected to Receive Development Assistance through 2020

According to our analysis of World Bank and IMF projections, the expected level of development assistance for the 27 countries is $153 billion through 2020. This estimate assumes that the countries will follow their World Bank and IMF development programs, including undertaking recommended reforms. It also assumes that countries achieve economic

[15]When IDA performed the analysis, 19 countries were between the decision and completion points, and 8 had reached their completion points for a total of 27 countries. Currently, 11 countries have reached their decision points, and 16 are between decision and completion points.

growth rates consistent with reducing poverty and maintaining long-term debt sustainability.[16] These conditions will help countries meet their development objectives, including the Millennium Development Goals that world leaders committed to in 2000. These goals include reducing poverty, hunger, illiteracy, gender inequality, child and maternal mortality, disease, and environmental degradation. Another goal calls on rich countries to build stronger partnerships for development and to relieve debt, increase aid, and give poor countries fair access to their markets and technology.

Countries Face a Substantial Financial Shortfall in Export Earnings

We estimate that 23 of the 27 HIPC countries will earn about $215 billion less from their exports than the World Bank and IMF project. The World Bank and IMF project that all 27 HIPC countries will become debt sustainable by 2020 because their exports are expected to grow at an average of 7.7 percent per year. However, as we have previously reported, the projected export growth rates are overly optimistic.[17] We estimate that export earnings are more likely to grow at the historical annual average of 3.1 percent per year—less than half the rate the World Bank and IMF project. Under lower, historical export growth rates, countries are likely to have lower export earnings and unsustainable debt levels (see table 2). We estimate the total amount of the potential export earnings shortfall over the 2003 to 2020 projection period to be $215 billion.[18]

[16]Debt sustainability under the current HIPC standard is defined as a present value external debt stock-to-export ratio less than or equal to 150 percent. The World Bank and IMF established a different debt sustainability indicator for countries with very open economies. Because these countries have a large export base compared with other measures of debt servicing capacity, the fiscal criterion of present value debt-to-fiscal revenues (250 percent) is considered a more appropriate debt sustainability measure. The four countries that qualify under this criterion are Ghana, Guyana, Honduras, and Senegal.

[17]U.S. General Accounting Office, *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative*, GAO/NSIAD-98-229 (Washington, D.C.: Sept. 30, 1998); *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, GAO/NSIAD-00-161 (Washington, D.C.: June 29, 2000); *Developing Countries: Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens*, GAO-02-593 (Washington, D.C.: Apr. 19, 2002); and *Developing Countries: Challenges Confronting Debt Relief and IMF Lending to Poor Countries*, GAO-01-745T (Washington, D.C.: May 15, 2001).

[18]If future export growth rates exceed historical levels, the projected export earnings shortfall would be lower. We estimate that for every percentage point increase (decrease) in export growth rates from the historical average, the export earnings shortfall would decrease (increase) by about $35 billion.

Table 2: World Bank/IMF and Historical Export Growth Rates, Debt-to-Export Ratios, and Export Earnings Shortfall

	Debt-to-export ratios in 2020 (percentage)		Export growth rates (percentage)		
	Under World Bank/IMF growth rate	Under historical growth rate[a]	World Bank/IMF (projected)	Historical (1981-2000)	Export earnings shortfall (billions of dollars)
Benin	80.6	150.9	8.3	5.1	3.7
Bolivia	122.5	225.7	7.6	4.0	13.6
Burkina Faso	118.3	477.9	9.0	1.4	4.4
Cameroon	71.1	228.5	6.3	-0.1	29.7
Chad	119.5	137.0	11.9	7.9	8.2
DRC	90.6	625.9	9.4	-3.2	21.8
Ethiopia	75.5	199.0	8.0	2.9	11.7
The Gambia	83.2	75.9	6.3	7.5	0.0
Ghana	94.5	81.1	6.6	8.0	0.0
Guinea	90.3	217.2	6.6	1.7	8.7
Guinea-Bissau	120.1	153.7	8.8	7.8	0.4
Guyana	49.8	48.7	3.7	4.2	0.0
Honduras	31.3	46.0	9.4	7.2	24.2
Madagascar	79.0	111.0	7.7	6.0	5.9
Malawi	121.6	132.5	4.8	4.3	0.4
Mali	139.7	119.0	6.3	6.9	0.0
Mauritania	82.9	236.1	6.3	1.3	3.9
Mozambique	40.6	79.7	10.3	5.2	21.1
Nicaragua	59.6	94.3	8.0	5.7	6.9
Niger	137.5	643.2	7.0	-1.6	3.8
Rwanda	131.6	1,403.7	10.7	-3.6	4.2
São Tomé and Príncipe	144.0	946.3	7.4	-4.2	0.4
Senegal	56.9	98.7	6.0	3.0	11.2
Sierra Leone	104.3	831.8	9.1	-3.4	2.9
Tanzania	117.1	149.2	7.0	6.2	5.3
Uganda	104.3	263.8	9.5	4.3	9.6
Zambia	100.7	270.3	6.6	0.6	12.3
Average	**95.1**	**298.0**	**7.7**	**3.1**	**Total 214.5**

Source: GAO analysis of IMF and World Bank debt sustainability analyses.

[a]This analysis assumes countries incur no further debt as a result of their export earnings shortfall. Under this assumption, 12 countries are projected to be sustainable: Chad, The Gambia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mozambique, Nicaragua, Senegal, and Tanzania.

High export growth rates are unlikely because HIPC countries rely heavily on primary commodities such as coffee, cotton, and copper for much of their export revenue. Historically, the prices of these commodities have fluctuated, often downward, resulting in lower export earnings and worsening debt indicators. A 2003 World Bank report found that the World Bank/IMF growth assumptions had been overly optimistic and recommended more realistic economic forecasts when assessing debt sustainability.[19]

Since HIPC countries are assumed to follow their World Bank and IMF reform programs, any export shortfalls are considered to be caused by factors outside their control such as weather and natural disasters, lack of access to foreign markets, or declining commodity prices. Although failure to follow the reform program could result in the reduction or suspension of development assistance, export shortfalls due to outside factors would not be expected to have this result. Therefore, if countries are to achieve economic growth rates consistent with their development goals, donors would need to fund the $215 billion shortfall. Without this additional assistance, countries would grow more slowly, resulting in reduced imports, lower gross domestic product (GDP), and lower government revenue. These conditions could undermine progress toward poverty reduction and other goals.

Additional Assistance Will Lead to Debt Sustainability in Most Countries

Even if donors make up the export earnings shortfall, more than half of the 27 countries will experience unsustainable debt levels.[20] We estimate that these countries will require $8.5 to $19.8 billion more to achieve debt sustainability and debt-service goals.[21] After examining 40 strategies for providing debt relief, we narrowed our analysis to three specific strategies: (1) switching the minimum percentage of loans to grants for future multilateral development assistance for each country to achieve debt

[19]World Bank, Operation Evaluations Department, *The Heavily Indebted Poor Countries Debt Initiative, An OED Review*, February 20, 2003.

[20]Under historical export growth rates, countries experience unsustainable debt levels. These debt levels can be reduced regardless of whether donors address the export earnings shortfall. However, if donors do not fund the export earnings shortfall, countries will likely experience significant reductions in economic growth.

[21]This estimate assumes that donors fund the $215 billion export shortfall with grants only, as grants avoid the build up of new debt.

sustainability,[22] (2) paying debt service in excess of 5 percent of government revenue, and (3) combining strategies (1) and (2). We chose these strategies because they maximize the number of countries achieving debt sustainability while minimizing costs to donors.[23] We found that, with this debt relief, as many as 25 countries could become debt sustainable[24] and all countries would achieve a debt service-to-revenue ratio below 5 percent over the entire 18-year projection period (see table 3).

Table 3: Cost and Impact of Three Strategies for Providing Debt Relief to 27 Poor Countries

	Strategy	Cost of debt relief (billions of dollars)	Number of countries achieving debt sustainability in 2020	Number of countries paying 5 percent or less of revenue in debt service every year 2003-2020
1.	Switch the minimum percentage of loans to grants for each country to achieve debt sustainability	$8.5	25	2
2.	Pay debt service in excess of 5 percent of government revenue	$12.6	12	27
3.	Switch the minimum percentage of loans to grants and then pay debt service in excess of 5 percent of revenue	$19.8	25	27

Source. GAO analysis of World Bank and IMF data.

In the first strategy, multilateral creditors switch the minimum percentage of loans to grants for each country to achieve debt sustainability in 2020. We estimate that the additional cost of this strategy would be $8.5 billion.[25] The average percentage of loans switched to grants for all countries under

[22]Of the $153 billion in expected future development assistance, $75 billion is comprised of loans from the multilateral development banks. This strategy would switch the minimum amount of these loans to grants to achieve debt sustainability. Because these loans would raise a country's debt to an unsustainable level under historical growth rates, we consider switching them to grants to be the equivalent of debt relief.

[23]Our analysis assumes that under historical export growth rates, countries will have difficulty repaying their future debt burdens. As such, we did not take into account any reduction in future costs to bilateral donors that could arise if HIPCs were able to repay their multilateral loans.

[24]Niger and Rwanda do not achieve debt sustainability, even with 100-percent grants, because their historical export growth rates are negative and their existing debt levels are high.

[25]This cost represents loan receipts from 2003 to 2060 that are forgone after switching a percentage of new loans to grants.

this strategy would be 33.5 percent.[26] Twelve countries are projected to be debt sustainable with no further assistance. In addition, 13 countries would achieve sustainability by switching between 2 percent (Benin) and 96 percent (São Tomé and Príncipe) of new loans to grants. A total of 25 countries could be debt sustainable by 2020, although only 2 countries would achieve the 5-percent debt service-to-revenue target over the entire period.

The second strategy is aimed at reducing each country's debt-service burden. Under this strategy, donors would provide assistance to cover annual debt service above 5 percent of government revenue. We estimate that this strategy would cost an additional $12.6 billion to achieve the goal of 5-percent debt service to revenue for all countries throughout the projection period. Under this strategy, no additional countries become debt sustainable other than the 12 that are already projected to be debt sustainable with no further assistance. While this strategy would free significant resources for poverty reduction expenditures, it could provide an incentive for countries to pursue irresponsible borrowing policies. By guaranteeing that no country would have to pay more than 5 percent of its revenue in debt service, this strategy would separate the amount of a country's borrowing from the amount of its debt repayment. Consequently, it could encourage countries to borrow more than they are normally able to repay, increasing the cost to donors and reducing the resources available for other countries.

The third strategy combines strategies 1 and 2 to achieve both debt sustainability and a lower debt-service burden. Under this strategy, multilateral creditors would first switch the minimum percentage of loans to grants to achieve debt sustainability, and then donors would pay debt service in excess of 5 percent of government revenue. We estimate that this strategy would cost an additional $19.8 billion, including $8.5 billion for switching loans to grants, and $11.3 billion for reducing debt service to 5 percent of revenue. Under this strategy, 25 countries would achieve debt sustainability in 2020—that is, 13 countries in addition to the 12 that are projected to be debt sustainable with no further assistance. All 27 countries would reach the 5-percent debt-service goal for the duration of

[26]The percentage of loans switched to grants necessary to achieve debt sustainability varies by country and results in different costs and impacts for each country. For a breakdown of costs and impact by country, see U.S. General Accounting Office, *Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, GAO-04-405 (Washington, D.C.: Apr. 14, 2004).

the projection period. However, similar to the debt-service strategy above, this strategy dissociates borrowing from repayment and could encourage irresponsible borrowing policies.

If the United States decides to help fund the $375 billion, we estimate that it could cost approximately $52 billion over 18 years, both in bilateral grants and in contributions to multilateral development banks. This amount consists of $24 billion, which represents the U.S. share of the $153 billion in expected development assistance projected by the World Bank and IMF, as well as approximately $28 billion for the increased assistance to the 27 countries. Historically, the United States has been the largest contributor to the World Bank and IaDB, and the second largest contributor to the AfDB, providing between 11 and 50 percent of their funding. The U.S. share of bilateral assistance to the 27 countries we examined has historically been about 12 percent.

Volatility in Export Earnings Likely to Further Increase the Cost of Achieving Debt Sustainability

We also analyzed the impact of fluctuations in export growth on the likelihood of these countries achieving debt sustainability. The export earnings of HIPC countries experience large year-to-year fluctuations due to their heavy reliance on primary commodities, as well as weather extremes, natural disasters, and other factors.[27] We found that the higher a country's export volatility, the lower its likelihood of achieving debt sustainability. For example, Honduras has low export volatility, resulting in little impact on its debt sustainability. In contrast, Rwanda has very high export volatility, which greatly lowers its probability of achieving debt sustainability. Since volatility in export earnings reduces countries' likelihood of achieving debt sustainability, it is also likely to further increase donors' cost as countries may require an even greater than expected level of debt relief to achieve debt sustainability.

Mr. Chairman and Members of the Committee, this concludes my prepared statement. I will be happy to answer any questions you may have.

[27] While the previous analysis assumed constant export growth rates, consistent with the projections of the World Bank and IMF, the export earnings of HIPC countries are in fact highly volatile.

Contacts and Acknowledgments

For additional information about this testimony, please contact Thomas Melito, Acting Director, International Affairs and Trade, at (202) 512-9601 or Cheryl Goodman, Assistant Director, International Affairs and Trade, at (202) 512-6571. Other individuals who made key contributions to this testimony included Bruce Kutnick, Barbara Shields, R.G. Steinman, Ming Chen, Robert Ball, and Lynn Cothern.

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Subcommittee on Domestic and International Monetary Policy, Trade and Technology

Hearing entitled "HIPC Debt Relief: Which Way Forward?"

Tuesday, April 20, 2004

Question for Mr. Thomas Melito, Acting Director, International Affairs and Trade, United States General Accounting Office:

> Are you aware that the World Bank this year published research providing a substantially different assessment of projected debt-to-export ratios through 2023? The methodology rejects reliance on historical data alone being appropriate for projecting future debt service burdens. Are you familiar with the methodology used to generate this assessment? I would like to know the GAO's views on the merits of using historical projections to assess HIPC needs in light of the information and possible new methodology under review within the World Bank. The GAO report presents the views on using historical data, but does not assess its merits in relation to this new World Bank methodology.

Thank you.

Congresswoman Judy Biggert (R-IL)

The GAO closely reviewed the World Bank's and IMF's published research regarding stress testing of debt sustainability indicators for poor countries[1] prior to the publication of our recent report.[2] GAO does not consider the World Bank's and IMF's stress testing methodology to be superior to the use of historical export growth rates for the following reasons:

- Their "extreme" stress test considers the effects of only a single or combination of economic shocks in the first 2 years. After that shock, their test assumes that the overly optimistic baseline growth rates prevail through the remainder of the projection period, minimizing the shock's long-run impact on debt sustainability. However, historically these countries have experienced multiple shocks over time, due to factors such as natural disasters and a reliance on highly volatile primary commodities to generate export earnings.
- HIPC countries face the same vulnerabilities—most notably, dependence on primary agricultural commodities—now as in the past, increasing the relevance of historical export growth rates.
- The World Bank and IMF report states (see p. 28) that their stress test is not intended to address the impact of large shocks, which many HIPC countries have historically faced.
- The stress test model is not used to estimate the amount of assistance required to achieve debt sustainability and development objectives, in contrast to GAO'swork. As such, their suggested "policy adjustments" in response to external shocks outside these countries' control could negatively impact their income growth and their progress toward achieving their millennium development goals, despite the assumption that these countries are fully following their reform paths.

[1] *Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications*, prepared by the staffs of the IMF and World Bank, February 3, 2004.
[2] U.S. General Accounting Office, *Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, GAO-04-405, April 2004.

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